STATE OF THE ECONOMY: VIEW FROM THE FEDERAL RESERVE

HEARING

BEFORE THE

COMMITTEE ON THE BUDGET
HOUSE OF REPRESENTATIVES

ONE HUNDRED ELEVENTH CONGRESS

SECOND SESSION

HEARING HELD IN WASHINGTON, DC, JUNE 9, 2010

Serial No. 111–26

Printed for the use of the Committee on the Budget

Available on the Internet:
http://www.gpoaccess.gov/congress/house/budget/index.html

U.S. GOVERNMENT PRINTING OFFICE

56–847 PDF WASHINGTON : 2010

For sale by the Superintendent of Documents, U.S. Government Printing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512–1800; DC area (202) 512–1800
Fax: (202) 512–2104 Mail: Stop IDCC, Washington, DC 20402–0001

COMMITTEE ON THE BUDGET

JOHN M. SPRATT, JR., South Carolina, *Chairman*

ALLYSON Y. SCHWARTZ, Pennsylvania
MARCY KAPTUR, Ohio
XAVIER BECERRA, California
LLOYD DOGGETT, Texas
EARL BLUMENAUER, Oregon
MARION BERRY, Arkansas
ALLEN BOYD, Florida
JAMES P. McGOVERN, Massachusetts
NIKI TSONGAS, Massachusetts
BOB ETHERIDGE, North Carolina
BETTY McCOLLUM, Minnesota
JOHN A. YARMUTH, Kentucky
ROBERT E. ANDREWS, New Jersey
ROSA L. DeLAURO, Connecticut,
CHET EDWARDS, Texas
ROBERT C. "BOBBY" SCOTT, Virginia
JAMES R. LANGEVIN, Rhode Island
RICK LARSEN, Washington
TIMOTHY H. BISHOP, New York
GWEN MOORE, Wisconsin
GERALD E. CONNOLLY, Virginia
KURT SCHRADER, Oregon
DENNIS MOORE, Kansas

PAUL RYAN, Wisconsin,
Ranking Minority Member
JEB HENSARLING, Texas
SCOTT GARRETT, New Jersey
MARIO DIAZ–BALART, Florida
MICHAEL K. SIMPSON, Idaho
PATRICK T. McHENRY, North Carolina
CONNIE MACK, Florida
JOHN CAMPBELL, California
JIM JORDAN, Ohio
DEVIN NUNES, California
ROBERT B. ADERHOLT, Alabama
CYNTHIA M. LUMMIS, Wyoming
STEVE AUSTRIA, Ohio
GREGG HARPER, Mississippi
CHARLES K. DJOU, Hawaii

PROFESSIONAL STAFF

THOMAS S. KAHN, *Staff Director and Chief Counsel*
AUSTIN SMYTHE, *Minority Staff Director*

CONTENTS

STATE OF THE ECONOMY: VIEW FROM THE FEDERAL RESERVE

WEDNESDAY, JUNE 9, 2010

HOUSE OF REPRESENTATIVES,
COMMITTEE ON THE BUDGET,
Washington, DC.

The committee met, pursuant to call, at 10:10 a.m. in room 210, Cannon House Office Building, Hon. John Spratt [chairman of the committee] presiding.

Present: Representatives Spratt, Schwartz, Kaptur, Doggett, Tsongas, Etheridge, McCollum, Yarmuth, DeLauro, Edwards, Scott, Langevin, Bishop, Connolly, Schrader, Moore, Ryan, Hensarling, Garrett, Diaz-Balart, Simpson, Jordan, Aderholt, Lummis, Austria, and Djou.

Chairman SPRATT. We meet today to discuss the progress of the economic recovery and the challenges that still lie ahead of us. We are pleased, as I said, to have as our witness today the Chairman of the Federal Reserve system, Dr. Ben Bernanke.

When the 111th Congress began and the current administration took office, the economy was shrinking, contracting at an annualized rate of minus 5.4 percent. One year and a half later, the economy is experiencing its third straight quarter of economic growth, including 5.6 percent growth in the fourth quarter of 2009 and 3 percent growth in the first quarter of 2010. We have a chart to illustrate that.

A year and a half ago, the economy was losing jobs, hemorrhaging jobs. In the month of January 2009, we lost 779,000 jobs in one month alone. Now employers have added nearly a million jobs between January and May of this year. We have a chart that shows the job growth over the last span of time.

The ultimate strength of our economy lies in the private sector of course, but the actions taken by this Congress and by the administration have also played a significant role. For example, in the judgment of CBO, the Recovery Act, which we passed in July and February of 2009, has contributed significantly to the economic turnaround, raising real GDP by 1.7 to 4.2 percentage points in the fourth quarter of 2010 and increasing employment by between 1.2 million and 2.8 million jobs.

Meanwhile, the Treasury Department, the Federal Reserve, and the FDIC have engaged in unprecedented and coordinated efforts to stabilize banks and the financial system by injecting liquidity, capital, securing people's savings and requiring banks to raise still more capital.

While we as Democrats have been focused on the economic recovery, we have also been aware of the need to restore fiscal responsibility. We want to see the economy and the budget recover "pari passu," step by step.

Unlike the previous administration, which inherited a $5.6 trillion surplus over 10 years and turned it into large deficits, the current administration was handed a $1.3 trillion deficit for 2010 alone and an $8 trillion deficit over the next 10 years.

While the recession and recovery efforts have taken an unavoidable toll on the budget in the short run, we are focused on bringing the deficit down as the economy recovers. We passed statutory PAYGO, requiring that new mandatory spending on revenue reductions be paid for. The President has established a bipartisan commission now at work to make recommendations to bring the deficit down to a sustainable level by 2015. The President has also proposed to freeze nonsecurity discretionary spending for 3 years.

Last month I introduced a bill to add to our fiscal tool box, an additional tool called expedited rescission which allows the President to sign a bill into law but at the same time recommend to us in the Congress the elimination of some items in the bill that have a budgetary cost.

We will continue to pursue these and other steps towards fiscal responsibility so that over the medium and long term we put the Nation on a fiscal path that will provide a foundation for a strong economy in the future. At the same time, the key concern in the short term remains the economic outlook.

As we continue to work on additional legislation to address the situation, we are fortunate to have Chairman Bernanke here to present his testimony and respond to our questions. Most fundamentally at a time when too many Americans continue to feel the effects of this recession and wonder when relief is going to come, we would like to hear Dr. Bernanke's view of how the recovery is progressing and what steps we can take, what constructive steps the government can take, to maximize the return of sustained economic strength.

Before we turn to Chairman Bernanke's testimony, I would like to extend a warm welcome to the newest member of the Budget Committee, Congressman Charles Djou from Hawaii. Welcome aboard. We are glad to have you on the committee. You were sworn in last month as the newest member of the House and we welcome him to Congress and in particular to the Budget Committee.

Before Dr. Bernanke's testimony, let me also turn to the ranking member, Mr. Ryan, for any statement he may care to make for an opening purpose. Mr. Ryan.

[The statement of Mr. Spratt follows:]

PREPARED STATEMENT OF HON. JOHN M. SPRATT, JR., CHAIRMAN, COMMITTEE ON THE BUDGET

We convene today to discuss the progress of the economic recovery and the challenges that lie ahead. We are pleased to have as our witness the Chairman of the Board of Governors of the Federal Reserve System.

This economic crisis has profoundly affected the lives of so many Americans, and the task of restoring the strength of our economy and putting in place a foundation for enduring prosperity has been and remains at the top of the priority list for Congress and the Administration.

While everyone agrees that more progress must be made, there clearly has been some noticeable improvement from where things stood a year and a half ago. When the 111th Congress began and the current Administration took office, the economy was shrinking at a 5.4 percent annualized rate; a year and a half later, the economy has experienced its third straight quarter of economic growth—including 5.6 percent growth in the fourth quarter of 2009 and 3.0 percent growth in the first quarter of 2010. A year and a half ago, the economy was hemorrhaging jobs—losing 779,000 jobs in January 2009 alone. Now, employers have added nearly 1 million jobs through between January and May of this year.

The ultimate strength of our economy lies in the private sector—our businesses and workers—but the actions taken by this Congress and this Administration have also played an important role. For example, in the judgment of the nonpartisan Congressional Budget Office, the Recovery Act passed in February 2009 has contributed significantly to the economic turnaround, raising real GDP by 1.7 to 4.2 percentage points in the first quarter of 2010, and increasing employment by between 1.2 million and 2.8 million jobs. Meanwhile, the Treasury Department, the Federal Reserve, and the FDIC have engaged in unprecedented and coordinated efforts to stabilize banks and the financial system by injecting liquidity, securing people's savings, and requiring banks to raise more capital.

While Democrats have been focused on economic recovery, we have also been cognizant of the need to restore fiscal responsibility. Unlike the previous Administration, which inherited a $5.6 trillion ten-year surplus and turned it into large deficits, the current Administration was handed a $1.3 trillion deficit for 2010 and an $8 trillion ten-year deficit. While the recession and recovery efforts take an unavoidable toll on the budget in the short run, we are focused on bringing the deficit down as the economy recovers.

We have passed statutory Pay-As-You-Go rule into law—to require that new mandatory spending or revenue reductions be paid for. We have passed a health care reform bill that reduces the deficit. The President has established a bipartisan commission—which is now hard at work—to make recommendations to bring the deficit down to a sustainable level by 2015. The President has proposed to freeze non-security discretionary spending for three years. Last month I introduced a bill to add to our fiscal toolbox an additional tool called "expedited rescission," which allows the President to sign a bill into law but at the same time recommend that Congress eliminate some items included in the bill that have a budgetary cost.

We will continue to pursue these and other steps toward fiscal responsibility so that over the medium and long term, we put the nation on a fiscal path that will provide the foundation for a strong economy in the future. At the same time, the key concern in the short term remains the economic outlook. As we continue to work on additional legislation to address the economic situation, we are fortunate to have Chairman Bernanke here to present his testimony and answer our questions.

Most fundamentally, at a time when too many Americans continue to feel the lingering effects of the recession, we would like to hear your view of how the recovery is progressing, and what constructive steps can be taken to maximize the return of sustained economic strength.

Before we turn to Chairman Bernanke's testimony, I would first like to extend a warm welcome to the newest member of the Budget Committee, Congressman Charles Djou from Hawaii. He was sworn in last month as the newest Member of the House of Representatives, and we welcome him to the Congress and to our Committee.

Before the witness's testimony, let me also turn to the Ranking Member, Mr. Ryan, for any statement that he may wish to make.

Mr. RYAN. Thank you, Mr. Chairman. And thank you for opening this hearing. I too want to start off by welcoming our newest member, Congressman Charles Djou of Hawaii. We look forward to working with you to tackle our fiscal and economic challenges. And it is exciting to see you and your family here and being sworn into Congress. And we are really looking forward to working with you. Welcome to the Nation's capital.

And welcome to you, Chairman Bernanke. It is appropriate you are coming here before our committee today to talk about the state of the economy because the health of the U.S. and global economy is increasingly intertwined with the budget and our fiscal issues that we deal with here in this committee.

Over the past few months we have watched as a sovereign debt crisis in Europe has boiled into a real troubling problem. We are seeing that the continent's economic recovery is being threatened and we see even global financial stability in general is being threatened. In some ways, we are seeing a replay of a similar dynamic which impaired global financial markets in 2008. The fear then was the systemic exposure to bad mortgage-related assets, but the fear now is driven by exposure to sovereign credit and the possibility of a debt-induced economic slump.

Ominously, interbank lending rates, like LIBOR, are on the rise and credit spreads have widened as investors have become much more risk averse. Volatility is up and the stock market is down. What we are watching in real-time is the rough justice of the marketplace and the severe economic turmoil that can be inflicted on profligate countries mired in debt. At the moment, the U.S. is at the periphery of the European debt crisis and has even reaped some short-term benefits like lower long-term interest rates as a result of the renewed global flight to safety.

But Americans are left to wonder. Could we one day find ourselves at the epicenter of such a crisis? Could a European style debt crisis one day happen right here in the United States? The answer is undoubtedly yes. And the sad truth is that inaction by policymakers to change our fiscal course is hastening this day of reckoning.

A brief look at the budget numbers shows that our current fiscal situation and its trajectory going forward is very dire. The budget deficit this year stands at $1.5 trillion, or just over 10 percent of GDP. Under the President's budget, the budget we are living under right now, the CBO tells us that the level of U.S. debt will triple by the end of the decade, meaning that in just a few short years, the U.S. is poised to join that group of troubled countries whose public debt absorbs a large and growing share of their economic output. A fiscal crisis in the U.S. is no longer an economic hypothetical but a clear and present risk to our economy, to society's most vulnerable citizens, and America's standing in the world.

As the example of Greece has shown, market forces and investor sentiment do not offer countries the luxury of time and delayed promises to get their fiscal house in order. Empty rhetoric is no substitute for results. Foreigners now own roughly half of the U.S. publicly held debt and their willingness to fund our borrowing at record low interest rates will not continue forever. The size of our current and future funding needs makes us quite vulnerable to a shift in market sentiment and higher than expected interest rates. The reemergence of the bond vigilantes and exposure to the rough justice of the marketplace would certainly make our bad fiscal situation even worse.

The main point here is the need for policymakers to reassure credit markets that the U.S. is engaged in charting a clear course back to sustainable deficit and debt levels soon. It is clear to me that this means reining in government spending, not simply ramping up taxes. In particular, we need to reform our entitlement programs, which threaten to grow themselves right into extinction, collapse our safety net, overwhelm the entire Federal budget and sink the economy in the process. The budding sovereign debt problems in other parts of the world provide us with a great cautionary tale that it is always best to take action to shore up budget deficits before market forces demand it.

So what has this Congress and administration done to respond? Two new entitlement programs and no budget. The majority's failure to even offer a budget and its commitment to continue spending money we don't have, creating brand new entitlements and plunging our Nation deeper into debt tells me, and tells the bond markets more importantly, that Washington still doesn't recognize the severity of our fiscal and economic challenges.

I look forward to your testimony today, Chairman Bernanke, and remain hopeful that policymakers will heed your warnings and chart a sustainable course to avert the next crisis. Thank you.

Chairman SPRATT. Now, before turning to the Chairman for his comments, let me ask unanimous consent that all members be allowed to submit an opening statement for the record at this point. Without objection, so ordered.

Dr. Bernanke, we welcome you before the committee. You have filed your testimony. We will make it part of the record. You can summarize it as you see fit. But you are the only witness today and we encourage you to take your time in responding and elaborating on the questions presented to you.

Thank you again for coming. The floor is yours.

STATEMENT OF HON. BEN S. BERNANKE, CHAIRMAN, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Mr. BERNANKE. Chairman Spratt, Ranking Member Ryan and other members of the committee, I am pleased to have this opportunity to offer my views on current economic and financial conditions and on issues pertaining to the Federal budget.

The recovery and economic activity that began in the second half of last year has continued at a moderate pace so far this year. Moreover, the economy, supported by stimulative monetary policy and a concerted effort of policymakers to stabilize the financial system, appears to be on track to continue to expand through this year and next. The latest economic projections of Federal Reserve Governors and Reserve Bank presidents, which were made near the end of April, anticipate that real gross domestic product will grow in the neighborhood of 3-½ percent over the course of 2010 as a whole and at a somewhat faster pace next year. If this pace of growth were to be realized, it would probably be associated with only a slow reduction in the unemployment rate over time. In this environment, inflation is likely to remain subdued.

Although the support to economic growth and fiscal policy is likely to diminish in the coming year, the incoming data suggests that gains in private final demand will sustain the recovery in economic activity. Real consumer spending has risen at an annual rate of nearly 3½ percent so far this year, with particular strength in the highly cyclical category or durable goods. Consumer spending is likely to increase at a moderate pace going forward, supported by a gradual pickup in employment and income, greater consumer confidence, and some improvement in credit conditions.

In the business sector, real outlays for equipment and software posted another solid gain in the first quarter and the increases were more broadly based than in late 2009. The available indicators point to continued strength in the second quarter. Looking forward, investment in new equipment and software is expected to be supported by healthy corporate balance sheets, relatively low cost of financing of new projects, increased confidence in the durability of the recovery, and the need of many businesses to replace aging equipment and expand capacity as sales prospects brighten. More generally, U.S. manufacturing output, which has benefited from strong export demand, rose at an annual rate of 9 percent over the first 4 months of this year.

At the same time, significant restraints on the pace of the recovery remain. In the housing market, sales and construction have been temporarily boosted lately by the home buyer tax credit. But looking through these temporary movements, underlying housing activity appears to have firmed only a little since mid-2009, with activity being weighed down in part by a large inventory of distressed or vacant and existing houses and by the difficulties of many builders in obtaining credit. Spending on nonresidential buildings also is being held back by high vacancy rates, low property prices, and strained credit conditions. Meanwhile, pressures on State and local budgets, though tempered somewhat by ongoing Federal support, have led these governments to make further cuts in employment and construction spending.

As you know, the labor market was hit particularly hard by the recession, but we have begun to see some modest improvement recently in employment, hours of work, and labor income. Payroll employment rose by 431,000 in May, but that figure importantly reflected an increase of 411,000 in hiring for the decennial consensus. Private payroll employment has risen an average of 140,000 per month for the past 3 months and expectations of both businesses and households about hiring prospects have improved since the beginning of the year. In all likelihood, however, a significant amount of time will be required to restore the nearly 8½ million jobs that were lost over 2008 and 2009.

On the inflation front, recent data continue to show a subdued rate of increases in consumer prices. For the 3 months ending in April, the price index for personal consumption expenditures rose at an annual rate of just ½ percent, as energy prices declined and the index excluding food and energy rose at an annual rate of about 1 percent. Over the past 2 years, overall consumer prices have fluctuated in response to large swings in energy and food prices. But aside from these volatile components, a moderation in inflation has been clear and broadly based over this period. To date, long-run inflation expectations have been stable, with most survey-based measures remaining within the narrow range that have prevailed for the past few years. Measures based on nominal index Treasury yields have decreased somewhat of late, but at least part of these declines reflect market responses to changes in the financial situation in Europe, to which I now turn.

Since late last year, market concerns have mounted over the ability of Greece and a number of other euro-area countries to manage their sizeable budget deficits and high levels of public debt. By early May, financial strains had increased significantly as investors focused on several interrelated issues, including whether the fiscally stronger euro-area governments would provide financial support to the weakest members, the extent to which euro-area growth would be slowed by efforts of fiscal consolidation, and the extent of exposure of major European financial institutions to vulnerable countries.

U.S. financial markets have been roiled in recent weeks by these developments, which have triggered a reduction in demand for risky assets. Broad equity market indexes have declined and implied volatility has risen considerably. Treasury yields have fallen as much as 50 basis points since late April, primarily as a result of safe-haven flows that boosted the demand for Treasury securities. Corporate spreads have widened over the same period and some issuance of corporate bonds have been postponed, especially by speculative grade issuers.

In response to these concerns, European leaders have put in place a number of strong measures. Countries under stress have committed to address their fiscal problems. A major assistance package has been established jointly by the European Union and the International Monetary Fund for Greece. To backstop near-term financing needs of its members more generally, the EU has established a European financial stabilization mechanism with up to 500 billion euros in funding, which could be used in tandem with significant bilateral support from the IMF. EU leaders are also discussing proposals to tighten surveillance of members' fiscal performance and improve the design of the EU's fiscal support mechanisms.

In addition, to address strains in European financial markets, the European Central Bank has begun purchasing debt securities in markets that it sees as malfunctioning. It has resumed auctions of 3 and 6-month loans of euros in unlimited quantities to borrowers with appropriate collateral. To help ease strains in U.S. dollar funding markets, the Federal Reserve has reestablished temporary U.S. dollar liquidity swap lines with the ECB and other major central banks. To date, drawings under these swap lines remain quite limited and far below their peaks reached at the height of the financial crisis in late 2008, but they are nevertheless providing an important backstop for the functioning of dollar funding markets. More generally, our ongoing international cooperation sends an important signal to global financial markets that we will take the actions necessary to ensure stability and continued economic recovery.

The actions taken by European leaders represent a firm commitment to resolve the prevailing stresses and restore market confidence and stability. If markets continue to stabilize, then the effects of the crisis on economic growth in the United States seem likely to be modest. Although the recent fall in equity prices and weaker economic prospects in Europe will leave some imprint on the U.S. economy, offsetting factors include declines in interest rates and Treasury bonds and home mortgages, as well as lower prices for oil and some other globally traded commodities. The Federal Reserve will remain highly attentive to developments abroad and to their potential effects on the U.S. economy.

Ongoing developments in Europe point to the importance of maintaining sound government finances. In many ways, the United

States enjoys a uniquely favored position. Our economy is large, diversified, and flexible; our financial markets are deep and liquid; and as I have mentioned, in the midst of financial turmoil, global investors have viewed Treasury securities as a safe haven. Nevertheless, history makes clear that failure to achieve fiscal sustainability will over time sap the Nation's economic vitality, reduce our living standards, and greatly increase the risk of economic and financial instability.

Our Nation's fiscal position has deteriorated appreciably since the onset of the financial crisis and the recession. The exceptional increase in the deficit has in large part reflected the effects of the weak economy on tax revenues and spending, along with the necessary policy actions taken to ease the recession and steady financial markets. As the economy and financial markets continue to recover and as the actions taken to provide economic stimulus and promote financial stability are phased out, the budget deficit should narrow over the next few years.

Even after economic and financial conditions have returned to normal, however, in the absence of further policy actions, the Federal budget appears to be on an unsustainable path. A variety of projections that extrapolate current policies and make plausible assumptions about the future evolution of the economy show a structural budget gap that is both large relative to the size of the economy and increasing over time.

Among the primary forces putting upward pressure on the deficit is the aging of the U.S. population, as the number of people expected to be working and paying taxes into various programs is rising more slowly than the number of people projected to receive benefits. Notably this year, about 5 individuals are between the ages of 20 and 64 for each person age 65 or older. By the time most of the baby boomers have retired in 2030, this ratio is projected to have declined to around 3. In addition, government expenditures in health care for both retirees and non-retirees have continued to rise rapidly as increases in the cost of care have exceeded increases in incomes. To avoid sharp disruptive shifts in spending programs and tax policies in the future and to retain the confidence of the public in the markets, we should be planning now how we will be meeting these looming budgetary challenges.

Achieving long-term fiscal sustainability will be difficult, but unless we as a nation make a strong commitment to fiscal responsibility in the longer run, we will have neither financial stability nor healthy economic growth. Thank you, Mr. Chairman. I am happy to take your questions.

[The prepared statement of Ben Bernanke follows:]

PREPARED STATEMENT OF HON. BEN S. BERNANKE, CHAIRMAN, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Chairman Spratt, Ranking Member Ryan, and other members of the Committee, I am pleased to have this opportunity to offer my views on current economic and financial conditions and on issues pertaining to the federal budget.

THE ECONOMIC OUTLOOK

The recovery in economic activity that began in the second half of last year has continued at a moderate pace so far this year. Moreover, the economy—supported by stimulative monetary policy and the concerted efforts of policymakers to stabilize the financial system—appears to be on track to continue to expand through this year and next. The latest economic projections of Federal Reserve Governors and Reserve Bank presidents, which were made near the end of April, anticipate that real gross domestic product (GDP) will grow in the neighborhood of 3½ percent over the course of 2010 as a whole and at a somewhat faster pace next year.[1] This pace of growth, were it to be realized, would probably be associated with only a slow reduction in the unemployment rate over time. In this environment, inflation is likely to remain subdued.

Although the support to economic growth from fiscal policy is likely to diminish in the coming year, the incoming data suggest that gains in private final demand will sustain the recovery in economic activity. Real consumer spending has risen at an annual rate of nearly 3½ percent so far this year, with particular strength in the highly cyclical category of durable goods. Consumer spending is likely to increase at a moderate pace going forward, supported by a gradual pickup in employment and income, greater consumer confidence, and some improvement in credit conditions.

In the business sector, real outlays for equipment and software posted another solid gain in the first quarter, and the increases were more broadly based than in late 2009; the available indicators point to continued strength in the second quarter. Looking forward, investment in new equipment and software is expected to be supported by healthy corporate balance sheets, relatively low costs of financing of new projects, increased confidence in the durability of the recovery, and the need of many businesses to replace aging equipment and expand capacity as sales prospects brighten. More generally, U.S. manufacturing output, which has benefited from strong export demand, rose at an annual rate of 9 percent over the first four months of the year.

At the same time, significant restraints on the pace of the recovery remain. In the housing market, sales and construction have been temporarily boosted lately by the homebuyer tax credit. But looking through these temporary movements, underlying housing activity appears to have firmed only a little since mid-2009, with activity being weighed down, in part, by a large inventory of distressed or vacant existing houses and by the difficulties of many builders in obtaining credit. Spending on nonresidential buildings also is being held back by high vacancy rates, low property prices, and strained credit conditions. Meanwhile, pressures on state and local budgets, though tempered somewhat by ongoing federal support, have led these governments to make further cuts in employment and construction spending.

As you know, the labor market was hit particularly hard by the recession, but we have begun to see some modest improvement recently in employment, hours of work, and labor income. Payroll employment rose by 431,000 in May, but that figure importantly reflected an increase of 411,000 in hiring for the decennial census. Private payroll employment has risen an average of 140,000 per month for the past three months, and expectations of both businesses and households about hiring prospects have improved since the beginning of the year. In all likelihood, however, a significant amount of time will be required to restore the nearly 8½ million jobs that were lost over 2008 and 2009.

On the inflation front, recent data continue to show a subdued rate of increase in consumer prices. For the three months ended in April, the price index for personal consumption expenditures rose at an annual rate of just ½ percent, as energy prices declined and the index excluding food and energy rose at an annual rate of about 1 percent. Over the past two years, overall consumer prices have fluctuated in response to large swings in energy and food prices. But aside from these volatile components, a moderation in inflation has been clear and broadly based over this period. To date, long-run inflation expectations have been stable, with most survey-based measures remaining within the narrow ranges that have prevailed for the past few years. Measures based on nominal and indexed Treasury yields have decreased somewhat of late, but at least part of these declines reflect market responses to changes in the financial situation in Europe, to which I now turn.

DEVELOPMENTS IN EUROPE

Since late last year, market concerns have mounted over the ability of Greece and a number of other euro-area countries to manage their sizable budget deficits and high levels of public debt. By early May, financial strains had increased significantly as investors focused on several interrelated issues, including whether the fiscally

[1] See "Summary of Economic Projections," an addendum to the April Federal Open Market Committee minutes, available at Board of Governors of the Federal Reserve System (2010), "Minutes of the Federal Open Market Committee, April 27-28, 2010," press release, May 19, www.federalreserve.gov/newsevents/press/monetary/20100519a.htm.

stronger euro-area governments would provide financial support to the weakest members, the extent to which euro-area growth would be slowed by efforts at fiscal consolidation, and the extent of exposure of major European financial institutions to vulnerable countries.

U.S. financial markets have been roiled in recent weeks by these developments, which have triggered a reduction in demand for risky assets: Broad equity market indexes have declined, and implied volatility has risen considerably. Treasury yields have fallen as much as 50 basis points since late April, primarily as a result of safe-haven flows that boosted the demand for Treasury securities. Corporate spreads have widened over the same period, and some issuance of corporate bonds has been postponed, especially by speculative-grade issuers.

In response to these concerns, European leaders have put in place a number of strong measures. Countries under stress have committed to address their fiscal problems. A major assistance package has been established jointly by the European Union (EU) and the International Monetary Fund (IMF) for Greece. To backstop near-term financing needs of its members more generally, the EU has established a European Financial Stabilization Mechanism with up to 500 billion euros in funding, which could be used in tandem with significant bilateral support from the IMF. EU leaders are also discussing proposals to tighten surveillance of members' fiscal performance and improve the design of the EU's fiscal support mechanisms.

In addition, to address strains in European financial markets, the European Central Bank (ECB) has begun purchasing debt securities in markets that it sees as malfunctioning, and has resumed auctions of three- and six-month loans of euros in unlimited quantities to borrowers with appropriate collateral. To help ease strains in U.S. dollar funding markets, the Federal Reserve has reestablished temporary U.S. dollar liquidity swap lines with the ECB and other major central banks. To date, drawings under these swap lines remain quite limited and far below their peaks reached at the height of the financial crisis in late 2008, but they are nevertheless providing an important backstop for the functioning of dollar funding markets. More generally, our ongoing international cooperation sends an important signal to global financial markets that we will take the actions necessary to ensure stability and continued economic recovery.

The actions taken by European leaders represent a firm commitment to resolve the prevailing stresses and restore market confidence and stability. If markets continue to stabilize, then the effects of the crisis on economic growth in the United States seem likely to be modest. Although the recent fall in equity prices and weaker economic prospects in Europe will leave some imprint on the U.S. economy, offsetting factors include declines in interest rates on Treasury bonds and home mortgages as well as lower prices for oil and some other globally traded commodities. The Federal Reserve will remain highly attentive to developments abroad and to their potential effects on the U.S. economy.

FISCAL SUSTAINABILITY

Ongoing developments in Europe point to the importance of maintaining sound government finances. In many ways, the United States enjoys a uniquely favored position. Our economy is large, diversified, and flexible; our financial markets are deep and liquid; and, as I have mentioned, in the midst of financial turmoil, global investors have viewed Treasury securities as a safe haven. Nevertheless, history makes clear that failure to achieve fiscal sustainability will, over time, sap the nation's economic vitality, reduce our living standards, and greatly increase the risk of economic and financial instability.

Our nation's fiscal position has deteriorated appreciably since the onset of the financial crisis and the recession. The exceptional increase in the deficit has in large part reflected the effects of the weak economy on tax revenues and spending, along with the necessary policy actions taken to ease the recession and steady financial markets. As the economy and financial markets continue to recover, and as the actions taken to provide economic stimulus and promote financial stability are phased out, the budget deficit should narrow over the next few years.

Even after economic and financial conditions have returned to normal, however, in the absence of further policy actions, the federal budget appears to be on an unsustainable path. A variety of projections that extrapolate current policies and make plausible assumptions about the future evolution of the economy show a structural budget gap that is both large relative to the size of the economy and increasing over time.

Among the primary forces putting upward pressure on the deficit is the aging of the U.S. population, as the number of persons expected to be working and paying taxes into various programs is rising more slowly than the number of persons projected to receive benefits. Notably, this year about 5 individuals are between the ages of 20 and 64 for each person aged 65 or older. By the time most of the baby boomers have retired in 2030, this ratio is projected to have declined to around 3. In addition, government expenditures on health care for both retirees and non-retirees have continued to rise rapidly as increases in the costs of care have exceeded increases in incomes. To avoid sharp, disruptive shifts in spending programs and tax policies in the future, and to retain the confidence of the public and the markets, we should be planning now how we will meet these looming budgetary challenges.

Achieving long-term fiscal sustainability will be difficult. But unless we as a nation make a strong commitment to fiscal responsibility, in the longer run, we will have neither financial stability nor healthy economic growth.

Chairman SPRATT. Thank you. We have just come through the worst recession since the Great Depression, and we seem to have turned the corner. Looking back, if we had not taken the extraordinary steps that we took, starting with the TARP solicitation by the Bush administration, the Recovery Act by the Obama administration and many other fiscal and monetary steps in between, where would we be now? Do you think that those steps have been vindicated by events?

Mr. BERNANKE. Yes, Mr. Chairman, I do. We and other countries around the world took strenuous measures in the fall of 2008 to avert the collapse of the global financial system and to restore appropriate functioning to global financial markets. It took a while for that to work, but currently financial markets are in much better shape obviously than they were a year and a half ago. Monetary and fiscal policy have been quite supportive and also added to growth. So we see at this point a moderate recovery, not as fast as we would like, but certainly we have averted what I think would have been, absent those interventions, an extraordinarily severe downturn and perhaps a great depression.

Chairman SPRATT. Could you have dealt with that problem with monetary policy alone? With the countercyclical efforts that we took, would monetary policy by itself have been sufficient?

Mr. BERNANKE. Sufficient depends on your comparison of cost and benefits. But I think that the fiscal policy, based on what we know about previous episodes of fiscal policy and the analysis we have been able to do, that it did increase growth and add to job creation.

Chairman SPRATT. You seem to acknowledge in your testimony that we have turned the corner. It appears that we have, pulling out of the recession, back on a path to growth. But you also will see a need for accommodative monetary policy for some months to come. Does that indicate that you are concerned about a double dip, about the possibility of a relapse?

Mr. BERNANKE. Mr. Chairman, forecasting is very difficult and I can make no promises in any particular direction. But it appears to us that the recovery has made an important transition from being supported primarily by inventory dynamics and by fiscal policy toward recovery being led now more by private final demand, including consumer spending. That is encouraging in terms of the sustainability. So our current most likely outlook is that the economy will continue to recover at a moderate pace. Of course a double dip can never be entirely ruled out, of course. But right now our expectation is that the economy will continue to grow at around a 3 to 4 percent pace this year.

Chairman SPRATT. If I open the mics up—and we will before the hearing is over—to each member, each member here could give you some anecdotal accounts, some compelling accounts of a creditworthy constituent who has not been able to find credit. What have we got to do to get credit moving and flowing in this country again? Because the growth rate depends critically, I think, on having adequate capital in the form of borrowable money.

Mr. BERNANKE. Mr. Chairman, that is also a top priority for the Federal Reserve. Our stabilization, our work with the financial markets has restored something close to normal functioning in the public capital markets, the securities markets. So larger firms who have access to the commercial paper market, the corporate bond market, the equity market have been able to raise funding as needed. And in addition, they have pretty liquid balance sheets. Problems still remain for smaller firms that are dependent on banks because banks, although they have stabilized, are continuing to be very conservative in their lending policies.

The Federal Reserve, I would be happy to talk about this in quite a bit of detail if time permits. But very briefly, the Federal Reserve has been working very closely with the banks and with the examiners and with small business—I was just at a conference on this last week in Detroit—trying to make sure that the banks are able to lend to all creditworthy borrowers and they are not being excessively conservative or denying good borrowers access to credit.

Chairman SPRATT. Are you satisfied that that message is getting down to the regulators and the examiners in particular?

Mr. BERNANKE. I am never satisfied. I am sure that there are examples that we could point to where that is not happening. But we have made a very substantial effort in terms of training, in terms of conference calls, in terms of repeated exhortation to our examiners that it is very important to work with the banks to make sure that creditworthy borrowers are not turned away.

The banks themselves have undertaken a number of steps. For example, a number of banks have undertaken so-called second-look programs where loans that have been denied in the first round application are given a second look to see if perhaps there might be other circumstances that might justify the loan.

Chairman SPRATT. Until recently, the Fed was buying mortgages in the secondary market, creating a market itself. You have stopped doing that now. What is the role of Freddie Mac and Fannie Mae as we go forward with the recovery?

Mr. BERNANKE. Mr. Chairman, currently we are kind of in a transition period. As you know, Freddie and Fannie are in conservatorship. They are playing a very important role at the moment in providing a source of securitization for home mortgages. The private label mortgage backed security market is pretty much nonfunctional. Going forward, though, we need to get to a more sustainable situation. And I would be happy to talk about alternative models of reform. But I think everybody agrees that the current situation, the status quo, is not a sustainable one. We are going to need to reform those institutions going forward.

Chairman SPRATT. One final question. As you look back and bring your view up until recently, we have seen catastrophe after catastrophe occur that was not really fully appreciated or fully foreseen at that period in time, the euro is a good example, the failure of major institutions in 2008 and 2009 is another good example. Are the Fed and then the other monetary authorities, financial institution authorities in the Federal Government, do you think that you need a better distant early warning system, something that would give you a better lead time in recognition of events, incipient events that are about to turn critical?

Mr. BERNANKE. There are multiple dimensions about how to address this, and the financial regulatory reform legislation attempts to look at all the components. First, we need to have a better oversight of the system and more macro prudential or systemic approach to regulation that will allow us to identify gaps and problems before they lead to a crisis. That is part of the philosophy underlying the creation of a Systemic Risk Council and giving the Federal Reserve consolidated supervision over large, systemically critical firms.

Secondly, we need to make the system more resilient so that when crises occur it will be more stable. We are doing that through a wide variety of mechanisms, including increased capital requirements, increased liquidity requirements, efforts to make derivatives trading more transparent and the like.

And thirdly, if a crisis does occur, we need the tools to manage it. And there, very importantly, Congress has been working on alternative mechanisms for safely winding down, putting in receivership a large systemically critical firm so that it can fail without bringing down the rest of the system.

So those are three dimensions of our response I think we are making progress towards. We will never eliminate financial crises, but we need to make sure that they are much less frequent, that they are less virulent and they have less effect on the economy.

Chairman SPRATT. Thank you very much.

Mr. Ryan.

Mr. RYAN. Thank you, Chairman. It is good to have you back. Sovereign CDS spreads have driven back upwards in recent weeks. Some countries' bond yields, I think Spain and Italy, reached fresh highs this week. And the European funding markets are still pretty tight. In your opinion, is the ECB doing everything it needs to do from a policy action standpoint to stem this crisis? How do you gauge the risk of contagion with this crisis spilling over? And what is the endgame if conditions get worse?

Mr. BERNANKE. This is a joint effort of a number of European authorities, including the European Union, the European Commission, and the ECB. It is a complicated problem because there are a number of countries that have difficult fiscal situations. The concern is that those countries cannot manage their fiscal positions on their own and that there might potentially be contagion to other countries or potentially to the banking system.

So those are the concerns that are being faced. I am encouraged by the response of the Europeans. Although they lack the central fiscal authority that the United States has, they have understood the importance of cooperation and they have put together some very substantial programs including, as you know, a 500 billion euro stabilization mechanism that will stand behind countries on the periphery that need assistance in meeting their fiscal obligations, together with the IMF also providing substantial bilateral assistance. The goals of those programs—and they are quite substantial—will be to make sure that these countries are able to meet their obligations and to achieve fiscal sustainability.

I think the markets remain uncertain about whether these measures will be successful. That is why you are still seeing a lot of volatility in the markets. What I can assure you of is that the European leadership is fully committed to addressing this problem, preserving the euro zone and preserving the European Union. And they are working, I think, very aggressively right now to try to establish some effective solutions.

Mr. RYAN. Let us go over the monetary policy and global currency policy. The ECB is essentially engaged in quantitative easing. I know that they would argue that that is not per se their policy objective, but their objective is obviously liquidity for sovereign credit markets. The Federal Reserve has been engaged in a similar process lately. So we have now two reserve currencies engaged in a quantitative easing, the spirit of a quantitative easing policy. Gold hit an all-time high yesterday, which I think most people would view as a vote of no confidence against fiat currencies. I am interested in what does that price signal tell you and what is your view on the long-term repercussions with respect to weak currency policies?

I suppose one could argue that we don't have a weak dollar because everybody else is so much weaker. But with this kind of quantitative easing policy in place, we have sort of removed one of the firewalls that have separated our monetary and fiscal policy and that has probably changed investor impressions looking into the future with respect to the stability and strength of our currency. What is your view on that?

Mr. BERNANKE. The signal that gold is sending is in some ways very different from what other asset prices are sending. For example, the spread between nominal and inflation index bonds, the breakeven remains quite low, suggests that markets expect about 2 percent inflation over the next 10 years. Other commodity prices have fallen quite severely, including oil prices and food prices. So gold is out there doing something different from the rest of the commodity group. I don't fully understand the movements in the gold price, but I do think that there is a great deal of uncertainty and anxiety in financial markets right now and some people believe that holding gold will be a hedge against the fact that they view many other investments as being risky and hard to predict at this point.

Mr. RYAN. I think most people would agree that we don't have an inflation problem right now at our doorstep, that you could actually make an argument for disinflation or deflation as being potentially a risk. I am curious as to what do you look at to gauge inflation? It looks like you are really on this output gap model. You are using tip spreads, you are using consumer surveys. What leading indicators do you look at to inform your view on the future possibility of inflation? And how much do you put stock in those leading indicators?

Mr. BERNANKE. Well, you pointed to a number of them. Certainly we look at resource utilization and price and wage pressure, which is very low right now. With the increases in productivity we are seeing, unit labor costs are actually declining. So firms are finding that their labor costs are actually falling rather than rising. Inflationary expectations are very, very important. And we take some comfort from the fact that as measured through a variety of mechanisms they have been quite stable. And we look broadly at the economy, at commodity prices and a variety of other indicators to see what markets are anticipating. So it is a very eclectic process.

I guess what I would like to say is that even though we have indeed expanded our balance sheet, as you know and understand, I have given some testimonies in the last few months where I have laid out in some detail how we can exit from those extraordinary policies as needed, when needed without leaving any monetary or inflationary bias in the system. So we are comfortable that we have those tools.

Mr. RYAN. And the new tool you have is the ability to pay interests on reserves. My concern with this tool—and I just want to get your take on this—is we are talking about a credit crunch that our constituents are facing right now, especially if you are talking about rolling over the vintage of commercial real estate paper and the fact that people can't get their loans from their community banks. So there is a credit crunch right now. When you go in and charge interest on reserves to mop up the money supply once the velocity starts moving, it seems to me that you are just going to precipitate another credit crunch on top in order to mop up inflation. What is to make us think that we are not going to have tighter credit when the time comes around for your policy actions to be reversed?

Mr. BERNANKE. Congressman, it is exactly the same situation under any monetary policy tightening. When the Federal Reserve thinks that the economy is growing at more than a sustainable pace, it begins to raise interest rates precisely to reduce the demand for credit and to give an alternative to loans. So it is just the same as in any monetary——

Mr. RYAN. So we are looking at a tight credit period for quite some time it seems to me.

Mr. BERNANKE. Well, except that the pace and degree of our tightening will depend on what we see is necessary to get the economy on a sustainable growth path.

Mr. RYAN. Let us get to the growth, and this will be my last question. If my numbers are correct, the economy needs to create 250,000 jobs per month every month for 5 years straight if we want to get back to pre-recession unemployment levels. It is an incredible amount of job creation that is necessary. We can't keep taking the census every year. That is once every 10 years. So as the inevitable pullback on the spending occurs, the government spending occurs, and hopefully the kind of hiring of government workers does not keep on its pace because that involves other liabilities. Do you have confidence that the private sector will pick up the slack in employment to get unemployment going down fast? Three to 3½ percent growth doesn't strike me as sufficient enough to get back to these kinds of lower unemployment levels that we have enjoyed in this country. What is your view on that?

Mr. BERNANKE. Congressman, as I said in my testimony, I do think that private final demand, including exports but also consumer spending and investment, is taking the baton from fiscal policy and inventory accumulation to provide some source of growth. So in that respect, as we all would like to see, the private sector is beginning to take over this recovery. But at the same time, there is not much evidence at this point that the recovery will be robust enough, will be V-shaped enough if you will, to get us back to historically normal levels of unemployment in a short period of time. So that is the downside and the disappointment with this recovery.

Mr. RYAN. Is hitting the economy with higher tax rates on capital and income, especially for small businesses, going to help us get that growth up to where we need to go next year?

Mr. BERNANKE. We certainly want to get small businesses healthy and hiring as much as possible. We work, for example, very hard on credit for small businesses and they are an important source of job creation.

Chairman SPRATT. Before going to Ms. Schwartz, we have been informed by the Chairman's staff that you have a plane to catch at 12:30. So I am going to ride the 5-minute space pretty tightly.

Ms. Schwartz.

Ms. SCHWARTZ. Thank you very much. Thank you, Mr. Chairman, for your—I do want to follow up on, I think, some of the questions that have been asked and you have elaborated, and particularly Mr. Ryan's last set of questions about business growth, small business growth. We do see, many of us, as the answer, both in the short-term and the long-term, as growing jobs in the private sector. And particularly we have focused on the job growth in a small business. And we have taken a number of actions that we feel are making a difference. If you want to comment on some of them. And I wanted to ask you specifically about lending, for you to elaborate a bit more on small business lending. We have done investment tax credits, biotherapeutics, we may do them for biofuels as a way to incentivize small businesses that don't have assets to be able to take regular tax credits, can do investment tax credits.

We have extended bonus depreciation for small businesses, making capital investments. We have increased the cashflow for small business by providing a 5-year operating loss carryback. We have actually cut capital gains taxes for investments for small business, stocks would be extended, small business expensing. We have actually created tax credits for small businesses to provide health benefits.

And the President has a new initiative on exports, which you referenced very briefly on the importance—I will say it is the importance of expanding our export opportunities, particularly for small business. We tend not to think about the opportunities for small businesses to increase their outreach to the markets in the world and to be able to sell their products around the world. And there is an initiative the President has directly endorsed to double that export number. It is actually really quite small, unlike many other countries.

We are looking in the future in two areas to expand these investment tax credits as one way to help innovative new businesses, small businesses that have a hard time accessing capital.

And I wanted to know what you think of that. Because many of us do believe that the new technology businesses, some of them in the energy sector, some of them in the health sector, but more broadly are really a great growth area for the United States. We have always been on the cutting edge of innovation and technology.

And so I would ask you to comment on the actions we have taken, whether you think we should be continuing those, how much they have made a difference and will make a difference in expanding growth, small business growth in particular and we hope jobs. And secondly to expand on small business lending. We all hear it. We continue to hear it.

Our concern, as you pointed out, was making sure whether banks, which is where small businesses go for this lending, are acting too conservatively. They get mixed messages a bit from the regulators to say—and we agree that they have to make sure they have enough capital themselves. But they have got to get some dollars out the door. We are looking this week at small business lending legislation that would actually encourage banks through some Federal dollars to get those dollars out the door to small businesses.

And again I would highlight the interests we have in growth areas. Manufacturing, but particularly innovative entrepreneurs who are out there, want to take these steps and have a hard time accessing small business lending. Do you want to comment? I know you try not to comment on legislation, but the access to capital, what the Federal Government can do to encourage banks to do this. And again, more that we might be doing or that you might be able to do to encourage small business growth as one of the ways out of this difficult economy that I believe we have stabilized but really has a long way to go to create those jobs that we all want to see happen.

Mr. BERNANKE. You just gave a very good description. Small business is very important for job creation, particularly in a cyclical upturn. And I would say that in fact as we think about small business, we should also keep in mind startup businesses because they also provide a lot of job creation. So this is a very important part. It is our concern that too slow of a response on the small business side is one of the reasons why job creation is not as quick as we would like it to be. And I think it is important to try to remove the barriers and impediments for small business to expand.

You talked about tax policy, you and Mr. Ryan. I agree that we want to make tax policy as small business friendly as possible, to provide the right incentives, to give them the opportunities to invest and hire. Beyond that, though, I think for them to do that, first they need demand, they need sales. So we need to keep the economy growing, and the Federal Reserve is doing its part by maintaining a supportive monetary policy. But we also need to make sure they get credit. And I agree that that is very important as well. I am glad the Congress is exploring these different programs for making credit available. I think it is very useful to do that. Again from our own perspective, we have put bank lending and bank credit at the very top of our priority list and we have increased our information gathering, we have increased our consultation, we have increased our training of examiners. Basically we would like to know—if your constituents are telling you I have been turned down unfairly, we would like to hear about it. We have a hotline. We have a Website. Banks who have problems should talk to the directors of supervision at their local reserve bank. So we do want to know about it, and we will respond to it. But I certainly agree with your sentiments of what you said and we want to do everything we can to get small businesses——

Ms. SCHWARTZ. We look forward to—but I would like to follow up on the issue of startups. I think it is very hard for them to actually get a bank to lend to a new entrepreneur, a new company that is just starting up, the kind of dollars they might need to get through that first year or so, and how you assess that risk. So we have to follow up with you, and thank you for your positive comments.

Chairman SPRATT. Mr. Hensarling.

Mr. HENSARLING. Thank you, Mr. Chairman. Good morning, Chairman Bernanke. As you well know, Chairman Spratt, Ranking Member Ryan and myself serve on the President's Fiscal Responsibility Commission. You testified at our first meeting. At our second meeting, we received testimony from Dr. Carmen Reinhart at the University of Maryland, who presented, I believe, the most exhaustive study of debt crises that I am aware of, covering 44 nations over 200 years. She has come across with the conclusion to her study that when nations have a debt-to-GDP ratio of 90 percent that they will actually lose economic growth. Her study says, I believe the mean was 1 percentage point. So if your economic growth is averaging 3 percent, it would fall by a third to 2 percent. I think her study also showed that in the U.S., that in our Nation's history we actually have received negative economic growth at those points where debt to GDP has reached 90 percent. By a back of the envelope calculation, gross debt in the U.S. to GDP is now 89 percent. I know debt held by the public, I believe, is closer to 60 percent.

My question is are you familiar with the professor's study? Are you familiar with her conclusions? Do you agree or disagree?

Mr. BERNANKE. I am familiar with her study, and I would say that her book with Ken Rogoff on debt crisis and financial crisis is an extraordinary piece of work that includes analyses of, as you say, dozens of crises. On this particular issue, I agree with the general point that as debt increases, interest rates increase. That tends to make investments more costly, tax rates go up.

Mr. HENSARLING. I am sorry, since time is limited. Specifically gross debt to GDP of 90 percent where essentially we are at that tipping point now, do you believe that the U.S. is at a tipping point with respect to its debt?

Mr. BERNANKE. I don't think there is anything magic about 90 percent. However, I do think that if we were to go out as, say, the CBO's alternative scenario projects, then debt and interest payments are going to get explosive in 10 or 15 years. So I think we are close to a situation where we need to be paying very close attention to our fiscal sustainability.

Mr. HENSARLING. In your testimony, you speak about the European leaders, I think in your written testimony. Quote-unquote, European leaders have put in place a number of strong measures, countries under stress have committed to address their fiscal problems. I think it was yesterday, perhaps the day before, the new Prime Minister of the U.K. said the state of Britain's finances were, quote, even worse than we thought and warned of, quote, painful and unavoidable cuts. Germany's Chancellor Merkel was quoted as saying Germany faces, quote, serious difficult times. They announced a rather sizeable group of spending cuts to deal with their spending crisis, which she said were necessary for the future of our country.

When I look at Germany's deficit-to-GDP ratio, the U.K.'s deficit-to-GDP ratio, it seems to be comparable to our own. When I look at their debt-to-GDP ratio, of Germany and the U.K., again it appears to be comparable to our own in dealing with gross debt.

I am just curious, do you appear to be complimenting the European leaders for taking strong stands, yet do you see similar strong stands being taken by this particular Congress to rein in the debt?

Mr. BERNANKE. Well, countries have different amounts of fiscal capacity, if you will. Countries like Greece, which are clearly being shut out from the market because of their debt and deficit ratios, need immediate and sharp changes in their position. The United States, as I said in my remarks, is favored in that we are a safe-haven currency, we are a large diversified economy, and we have a long record of paying our debts, paying our interest. So we have a little more breathing space potentially, but I don't know exactly how much we have. And what I am just trying to say—I don't think I am disagreeing with you—is that we need a program for returning our trajectory of fiscal policy to a sustainable path.

Mr. HENSARLING. Chairman Bernanke, my seconds are ticking away. Real quickly. Hopefully it is a yes or no question. I thought I have heard you testify before that not only is it important to the long-term sustainability that we have a program to deal with our debt, but it is actually important to economic growth today to send a signal that we have a plan in place. Did I understand you correctly? Is it important to have a plan today?

Mr. BERNANKE. You did. A plan in place will help keep interest rates down and help growth be stronger in the near term.

Mr. HENSARLING. Thank you, Mr. Chairman.

Chairman SPRATT. Thank you.

Mr. Doggett.

Mr. DOGGETT. Thank you for your testimony, Mr. Chairman. There is a report out today, as you know, that the Federal Reserve, 6 months into a compensation study of the country's 28 largest banks, has found that many of the bonus and incentive programs that economists say contributed to the worst financial crisis since the Depression remain in place. If the remainder of your study confirms that to be true, will the Fed do anything about it? Will it act this year rather than letting another year slip by? And what are some of the policy alternatives you have to deal with these compensation practices by our largest banks?

Mr. BERNANKE. Absolutely we are going to respond. We did a series of surveys and questionnaires to try to understand what the pay practices were and whether they were consistent with safe and sound banking and good incentive structures. As the report says, we found that many banks have not modified their practices from what they were before the crisis. We anticipate an interagency guidance on this matter within the next few weeks. So we will be putting out a set of criteria and a set of expectations very shortly, and we will be pushing the banks to move as quickly as possible to restructure their compensation packages so that they will not be engendering excessive risk taking. We will be doing that very quickly. We hope to have a public report about this near the end of this year or early next year. But I want to assure you that the actions we will be taking will not wait for the report. We will be immediately working with the banks, and we have been working with the banks already to get them to modify their compensation practices.

Mr. DOGGETT. You believe we will see real genuine change in compensation practices from before this downturn to now, that people will be able to tell the difference?

Mr. BERNANKE. The structure of the compensation practices needs to change so that there is not an incentive to take excessive risks. Packages where the trader gets all the upside and none of the downside, that is the kind of thing we are trying to get rid of.

Mr. DOGGETT. What do you believe would be the best estimate of the dollar cost to the taxpayers of TARP?

Mr. BERNANKE. Well, the direct cost for financial institutions, including AIG, I would say at this point it is not very large. Except for AIG, every other major institution has repaid with interest and dividends. And AIG I believe will repay. So the financial institution part, the direct cost is, I think, really quite small and may in the end be, in fact, a profit. That doesn't include some of the other uses to which TARP was put, such as the automakers support and the foreclosure program. The Treasury has provided numbers on those. I think they have an overall cost of about $110 billion for the program.

Mr. DOGGETT. Mr. Chairman, Ms. Schwartz made reference to the Small Business Lending Fund Act, which as you know is pending here in the House. Without getting into all the details of the legislation, do you believe that we need to take more action to assure the flow of credit to small businesses? Are the efforts that you have described that are underway at the Fed sufficient?

Mr. BERNANKE. Well, I think both the Fed and the Congress and the administration ought to be looking for new ways to get credit flowing because that—to my mind, that is one of the dangers to the recovery, that job creation and small business growth will not be sufficient to sustain the momentum. So I would ask you to put this on your priority list.

Mr. DOGGETT. Thank you. One of the areas that we have had some controversy over in the past is the concept of auditing the Fed. You made your views clear on that. The Senate narrowed significantly the audit provision that the House overwhelmingly passed. If something the same or similar to the Senate measure is adopted, how do you see that audit working?

Mr. BERNANKE. The Senate measure opens up all of our financial transactions, all of our financial controls, all of our financially related activities and therefore ensures that the taxpayers' money is as it is but you will be able to see that the taxpayers' money is well protected and well used. And that I have been saying from the very beginning, that we are absolutely comfortable with that and we are quite satisfied that we have an agreement to do that. We will cooperate in every possible way. We are already working with the GAO on AIG, for example. We will make sure that all this information is available to the public, that much of it already is. But whatever isn't will be put out.

The concern I had about the House version of the bill was that it also included an audit of monetary policy, which essentially involves Congress asking the GAO to evaluate the Fed's monetary policy decisions, which in my view is inconsistent with the independence of the Fed to make monetary policy decisions and would be disruptive to confidence in the Fed on the part of the markets and the public.

So I would strongly urge you to retain the 1979 exemption for monetary policy from GAO audits, which is not a financial audit, but a policy review. We are perfectly fine with prying open our books on all dimensions to the Congress to assure you that we are using the taxpayers' money appropriately.

Mr. DOGGETT. Thank you.

Chairman SPRATT. Mr. Garrett.

Mr. GARRETT. Thank you, Mr. Chairman. And I thank the Chairman. If I can have Chart 3 real quick just to reply to the chairman's opening remark. I will just speak on the political side of it. If you look at the grey, at 2004, 2005, 2006, 2007, memory serves that the President at that time would have been George Bush and for the first 3 years of that I guess the Republicans were in charge of the House. In the fourth year, 2007, is when the Democrats took it. But you are an economist. Can you tell us for year over year for the grey area there, for the first four bars, which way was the deficit going at that period of time, up or down?

Mr. BERNANKE. Well, of course you understand that the deficit jumped tremendously in 2009.

Mr. GARRETT. No, no, no. I just need to know the period of time from 2004, 2005, 2006 and 2007, year after year, the trend was up or down.

Mr. BERNANKE. I can see from the figure that you are showing me that it was down.

Mr. GARRETT. Thank you. So what we saw then during the time that President Bush was in office and the Republicans were in charge of the deficit, the deficit was going down. In 2007 I think Chairman Spratt took over the gavel here. In 2008, President Obama came into the White House. What is the trend then, speaking as an economist, where the deficits are going; is that up or down?

Mr. BERNANKE. We had a financial crisis and a recession that led to a big increase in the deficit, no question about it.

Mr. GARRETT. Thank you. Anyway, back to some of the points—I think that is clear. Back to the points that the gentleman from Texas made, and you made this also in Financial Services, that we need a plan now on one of the areas we talked about over there, the GSEs—and you are nodding your head yes?

Mr. BERNANKE. Yes.

Mr. GARRETT. We need a plan now to add what, certainty to the marketplace as far as where we are going to go in that area for the GSEs, and secondly, I will put it in one question, will that also mean to add certainty to the marketplace that we need a plan now as far as a budget as well for the economy going forward? For both GSEs and the budget, is that something essential in order to provide certainty to the marketplace?

Mr. BERNANKE. I think you want clarity on both those issues as soon as you practically can. Clearly one of the concerns that many businesses have is policy uncertainty about what is happening in Washington. And to the extent that we can provide clarity, that is certainly a good thing.

Mr. GARRETT. And by not providing that clarity in either one of those areas—because you are familiar with the financial service bill that is in the Senate right now has not a word really on the GSEs. And as you are familiar with this committee right now, we are in a point in time for the first time in almost 40 years that we haven't seen a budget out of there, without that certainty what would be your prognostication going forward if we don't have that certainty?

Mr. BERNANKE. I will repeat what I said, that those are very important issues and I hope Congress will move expeditiously to provide clarity.

Mr. GARRETT. And actually I will just add a little tail to that. So besides the budget and the GSEs, some of the other areas—I guess business is telling me they don't see certainty in basic tax policy and regulation and in also spending as well as far as—we could put up a chart here on where spending is going. How did those three factors play into either lack of certainty in the marketplaces or certainty in the marketplaces? Taxes, regulation, and spending.

Mr. BERNANKE. I hear the same thing that—uncertainty about the economy and about policy is a deterrent to expansion. My particular bailiwick is financial regulation, and I think it is important for us to try to clarify as quickly as possible, Congress and the regulators, what is going to be expected of banks, for example, in the future. And we want to do a good job. We want to turn out good legislation and good regulation, but we should try to clarify as soon as possible in order to avoid any retarding effects on investment and expansion.

Mr. GARRETT. I appreciate that.

Can you just clarify something for me also just on a side note here? I assume and I thought I heard a rumor to this effect—maybe it is out there already—has the Fed done a study internally or otherwise just to look at itself and to look at what have you learned over the last year and a half or so with regard to the whole financial crisis and the way you have worked and everybody else worked? Are they doing a study? Have they done a study?

Mr. BERNANKE. We have done a series of papers. We have done one on monetary policy, which was made public. We have done a number of papers on supervision practice, and they have been guiding us to a revamping of our supervisory structure. So we have been doing a number of different——

Mr. GARRETT. And as you know, we are about to move ahead on financial service reform in the next day, week, or something like that. Are all of those reports and studies that you have done available? And if so, can we have a copy of those so we know before we go into this and pass a law what you have learned?

Mr. BERNANKE. I will have to take an inventory of what we have. But what we have worked on is not so much the regulatory structure but our own supervisory execution of those rules. So that would be what we have looked at.

Mr. GARRETT. That might be beneficial to us. Could we have copies of that?

Mr. BERNANKE. We will see what we have. We will work with you.

Mr. GARRETT. If you do have something, is it possible to get a copy of it?

Mr. BERNANKE. Yes.

Mr. GARRETT. There you go. And I have used up all my time.

Thank you, Mr. Chairman.

Chairman SPRATT. Mr. Yarmuth.

Mr. Andrews of New Jersey.

Mr. Bishop of New York.

Mr. BISHOP. I am here, Mr. Chairman.

Thank you, Mr. Chairman for being here. Just, Mr. Garrett raised some questions that suggested that the explosion of the deficit has to do with Democratic policies. My understanding is that the CBO has conducted a study in which they have indicated that they believe that our long-term debt over the next 10 years, we are looking at an $8 trillion debt, and they have assessed that $5 trillion of that results from essentially two decisions: The 2001 and the 2003 tax cuts put on the national credit card, and the massive expansion of the Medicare part D program, again put on the national credit card. Are you familiar with that assessment from CBO? And if so, what is your take on it?

Mr. BERNANKE. Well, CBO does these baseline projections under current policy, and I am sure that the 2001, 2003 tax cuts and the part D would be important contributors to their projection of deficits over the next 10 years.

Mr. BISHOP. Is there any argument that can be made that the 2001 and the 2003 tax cuts were stimulative, given the meltdown that we have had in the economy over the last several years?

Mr. BERNANKE. Well, I think they were stimulative to some extent. Remember, we had a recession in 2001, and we had some recovery from that. The meltdown we had was a financial crisis which was somewhat unrelated to some of these fiscal issues.

Mr. BISHOP. Let me go quickly to the Recovery Act. You indicated, I think in response to a question from Mr. Spratt, that government interventions averted a more severe recession, if not a second-grade depression. Do you include the Recovery Act in your tabulation of government interventions?

Mr. BERNANKE. I believe the Recovery Act did create growth and jobs. It is very difficult to know exactly how much. But based on our analysis and past experience, I think it did contribute to the recovery.

Mr. BISHOP. And the Recovery Act was essentially—I am round-numbering it—$500 billion of spending, $300 billion of tax cuts. Has there been any assessment that you have put credence in that assesses which pieces of the Recovery Act were perhaps more impactful than others?

Mr. BERNANKE. I don't know of any studies of this particular episode. So I guess the answer is, no, I don't.

Mr. BISHOP. Let me ask it this way: When we had the Recovery Act on the floor in the House, the Republican alternative was a Recovery Act that consisted entirely of tax cuts; if I remember correctly, about $550 billion worth of tax cuts. You said before that predictions are difficult.

But what would have been the impact, or can you assess what the impact would have been, had we had only a Recovery Act that consisted of tax cuts? What, for example, what implications would that have had for the States? About $200 billion of our Recovery Act was direct assistance to States so that States would be able to maintain a level of services. So can you assess where we would be relative to the States and relative to employment if our only response had been tax cuts?

Mr. BERNANKE. I think you are asking me something that I can't do without more analysis. Tax cuts have incentive effects. They have spending effects. But as you point out, they would not have covered some of the State and local budgetary issues that you are referring to. I am sorry, I don't know how to answer that question.

Mr. BISHOP. I understand.

Mr. Chairman, thank you. I yield back.

Chairman SPRATT. Mr. Simpson.

Mr. SIMPSON. Thank you, Mr. Chairman.

And thank you for being here today, Chairman. The economy seems to react to almost everything you say. Sometimes it reacts to things Congress does or fails to do. You said earlier that we need a plan to deal with our—or at least a plan to deal with our long-term financial debt as important to current economic conditions. Is that correct?

Mr. BERNANKE. Yes.

Mr. SIMPSON. Does Congress's inability to even be able to pass a budget for this current year and, therefore, our inability to do our appropriations bills for this current year have a negative impact on our economy would you say? And if so, to what degree?

Mr. BERNANKE. Well, it is important for us to persuade the markets that we have the political will and the ability to address our long-term debt and deficit problems. So what you are saying is, you know, inability to pass a budget could be a negative in that respect.

I have to say, in all honesty, that so far, we are not seeing it in the markets. The interest rates remain quite low.

But certainly one of the things that the markets will assess is the political ability of the Congress to work together to develop a longer-term budget plan that will bring us back to sustainability.

Mr. SIMPSON. In terms of tax policy, you said it needs to be small-business friendly. Obviously, small businesses create a majority of the new jobs in this country. Does it need to be consumer-friendly also? And the reason I ask that is, is this a time to let taxes increase or to increase tax rates on anybody in our economy? And we have heard a lot about all the tax rates that we have decreased for small business and investment income and other types of things. What about increasing tax rates on consumers?

Mr. BERNANKE. I am trying to avoid, as you can see, trying to avoid getting into the detailed debates on specific measures.

Mr. SIMPSON. In general.

Mr. BERNANKE. In general, I think right now we have a broadly stimulative fiscal policy which at the moment is helping, is needed, that includes lower taxes and probably higher spending as well.

But I think in order for that to be sustainable, we need to have a plan in the medium term to bring us back down to a stable trajectory. And that is what is critical. As long as we have the confidence of the markets that we will be able to exit from this situation with a sustainable fiscal program, then I think we will be okay.

If the markets take the conclusion from our actions that we are unable to do that, then we face some risk that interest rates will go up, and markets will be unconvinced.

Mr. SIMPSON. Do markets care in this long-term fiscal plan to bring us back into some sort of balance, how much of it is based on fiscal restraint or spending restraint by Congress and how much of it would be a tax increase?

Mr. BERNANKE. I think it depends on the detailed structure of exactly what the spending and tax is. Again, I am trying to avoid taking sides on this because it is really up to Congress to make those decisions.

Mr. SIMPSON. Clearly, we need your expertise on it.

Mr. BERNANKE. Well, there are plenty of people that have that kind of expertise, including the Congressional Budget Office and others. But the point is that we need to find some combination of reforms, taxes, spending, however you want to put it together, that is going to assure markets that deficits will be kept under control over the medium and long term.

Mr. SIMPSON. One last question. The Chairman mentioned, are we looking at a double dip in the economy? I continue to hear concern about the commercial real estate market and that it is going to hit. It is going to be worse than the home mortgage market that drove us into the first recession. Are you concerned about that? And what are we doing about it?

Mr. BERNANKE. Well, we are concerned about it. Clearly, it is a very weak point in the economy. For many banks, particularly smaller- and medium-sized banks, it is a problem.

We have done a number of things. The Federal Reserve worked with the Treasury to develop a program to try to restart the commercial mortgage-backed security market. Beyond that, we have issued guidance to banks and commercial real estate, and we are trying to work with them to restructure commercial real estate loans and to find ways to manage troubled loans. So we are doing the best we can with the banks and with the markets.

There seems to be, I would say, a few glimmers of hope in this area. There is some stabilization of price in some markets, for example, but it does remain a very serious concern, and we are watching it very carefully.

Mr. SIMPSON. Thank you.

Thank you, Mr. Chairman.

Chairman SPRATT. Mr. Schrader.

Mr. SCHRADER. Thank you, Mr. Chairman.

Can we go back to Mr. Garrett's graph from earlier? Is that possible?

Mr. Bernanke, it is my understanding that, during the Clinton years, we had a $5-plus trillion surplus; and under the Bush years, we went to a deficit. Is that an accurate statement?

Mr. BERNANKE. In terms of CBO projections, that is right.

Mr. SCHRADER. On this graph here, as you can see, beyond 2007, we already start to see the uptick of the Bush administration policies and the deficit. In the 2009 bar, which is colorfully colored red in this case, how much of that 2009 bar is a result of the economic downturn in the Bush policies?

Mr. BERNANKE. A lot of the increase in the last couple of years and also some of the size of the deficit next year as well is a function of the financial crisis and the recession, absolutely.

What this picture doesn't completely capture is that in the medium term, the dominant factors will be the entitlement programs, Medicare, Medicaid, Social Security. Those will be the biggest cost factors in the medium term. This reflects the short-term movement in terms of the recession mostly.

Mr. SCHRADER. So of little value for long-term projection?

Mr. BERNANKE. Well, the recession component ought to go away, but we do need to deal with the structural component, the longer-term component.

Mr. SCHRADER. You talk in your testimony that GDP is going to grow about 3.5 percent from 2010. That is a pleasant change from the 6 percent downturns that we were seeing at the end of 2008 and early 2009 that came out of the Bush administration. You talk about a faster pace next year. What is that faster pace you are anticipating?

Mr. BERNANKE. There is a lot of uncertainty, but we are looking at sort of something around 3.5 to 4 percent next year.

Mr. SCHRADER. You also talk about the fiscal policy effects are going to diminish, obviously, as we withdraw the fiscal stimulus money that has been put into the system and kept out us of the depression. You talked about incoming data suggesting gains in private final demand. What incoming data are you looking at to project that?

Mr. BERNANKE. There are three areas where private final demand is relatively strong. The consumer has been pretty strong, which is a very important component. It is a big component, obviously. Equipment and software investment by firms, not construction but equipment, and exports have been strong. Those are the main components. The others are relatively weak.

Mr. SCHRADER. You also talked about manufacturing output, which has very well skyrocketed to 9 percent over the first 4 months. Is something like that sustainable? Where are we going to go in the future with U.S. manufacturing?

Mr. BERNANKE. Well, it is not sustainable indefinitely but manufacturing has rebounded very quickly, and was leading the economy out of the recession, which often happens. But in part, it is because manufacturing is trade-intensive, and as global trade has rebounded, manufacturing has taken advantage of that.

Mr. SCHRADER. Right now, there seems to be an impending crisis in the States in their budgets. We certainly are very mindful, as you have heard in the discussion today about our own fiscal situation here at the national government. But our States are potentially facing huge budget crises. I don't care—almost all the States—not all but almost all. What affect would massive public employee layoffs of teachers, police officers, and firefighters have on the recovery?

Mr. BERNANKE. Well, just in the same way that fiscal spending affects activity, the decline in those services would be reflected in slower growth presumably.

Mr. SCHRADER. So the recovery would be prolonged and deeper?

Mr. BERNANKE. Well, directly we see that those jobs would be lost and those services would be lost.

Mr. SCHRADER. Do you see any indication—based on your testimony, the Treasury yields are still pretty low and it seems to be a safe haven. Any indication in the near future that the U.S. Treasuries won't still be the preferred currency of the world going forward here?

Mr. BERNANKE. No. The dollar is still the dominant reserve currency, and U.S. Treasuries, obviously, are very attractive, as you can see from the increase in their prices during the recent turmoil. So the U.S. dollar has been a safe haven currency where investors have gone when they have been concerned about other currencies in other economies.

Mr. SCHRADER. Thank you very much.

I yield back.

Chairman SPRATT. Mr. Jordan.

Mr. JORDAN. Thank you, Mr. Chairman.

Dr. Bernanke, I appreciate you being with us today. On page 1 of your testimony, you offer a fairly optimistic projection of what you think is likely to happen in the near term and into next year.

You talk about expand through this year and next, and you talk about a 3.5 percent increase over the course of the rest of this year and a somewhat faster pace next year.

But there was a column earlier this week in the Journal by Art Laffer, who obviously comes from a particular school of economic thought, and he talks about the tax increases that are coming. We know they are going to happen. The top marginal rate is going to go up. The dividends rate is going to go up. The capital gains tax rate is going to go up. And the fundamental principle in economics is that government policies change people's behavior, and they have an impact.

I think about my home State of Ohio. We have a pretty high marginal tax rate, income tax rate. People leave because of that. Think of States like California with their tax rate. And you also, I think in the very first questions from the chairman, talked about the potential or the concern that is still out there about a double-dip recession.

So talk to me about those tax increases that we know are going to happen—I mean, the administration and this Congress have been very plain about that; they are going to raise those taxes—what impact that may have on the growth that you are expecting to continue through the remainder of this year and into next year.

Mr. BERNANKE. Well the timing is critical. We have a recovery underway now. So, in the very near term, increased taxes, cuts in spending that are too large would be a negative, would be a drag on the recovery.

At the same time, as Mr. Ryan and others have pointed out, we need to convince markets that in the medium and longer term, we have a sustainable fiscal path. So the ideal strategy in my view is to provide soon a plan for balancing our budget or at least bringing deficits down over the medium and longer term.

Now, again, I am not going to try to adjudicate for Congress exactly how that should be done. But I would say that, in the short term, that you should, as you look at fiscal issues, you should take into account the recovery and the strength of the recovery.

Mr. JORDAN. Well, let me pick up where you were about a plan in place. I would just point out that—and last year I offered on behalf of the Republican Study Committee the only balanced budget in Congress. We introduced it again 2 weeks ago. And frankly, I would invite you to take a look at that. We will get you a copy. We will give you the analysis of it, to look at that, the 10-year plan that actually reaches balance in the 9th and 10th year, does not impose tax increases. We think those are the right things. We think it strikes that balance you were just talking about. So I would ask you to take a look at that.

Let me just do one last question if I could. On page 5 of your testimony, you talk about the sustainability and how important it is and that if we don't get a plan in place or a path to sustainability, it will sap our Nation's economic vitality, greatly increase the risk of economic and financial instability. As the head of the Fed and speaking to this committee, speaking to the American people, in practical terms, if we don't get a plan, what does it mean to families across this country, what does it mean to the small business community? In real terms, how would you describe where we are headed if in fact we don't begin to turn this thing around, if we don't begin to get some common sense and make the tough decisions you have alluded to earlier in your answers? What it means in real terms to families and small business owners and taxpayers across this country, what it means for the Nation. And I will yield back.

Mr. BERNANKE. One of the main channels would be if confidence was lost in our long-term fiscal stability, we would see our interest rates go up quite a bit, as we have already seen in Greece and other countries. And that would affect, of course, the consumers' ability to buy houses and automobiles, et cetera. It would slow our economy. By reducing the value of government bonds, it would put pressure on the balance sheets of financial institutions. So it would cause a lot of stress on the economy. And in the worst case, it would cause financial instability like we are seeing, you know, to some extent in Greece.

So if you want a strong economy, you need to have capital investment. You need to have consumers' ability to buy houses and automobiles and so on. And the high interest rates that would make it even more difficult to balance the budget—because interest payments are a part of the deficit.

Mr. JORDAN. Interest rates are, I believe, within 2 years, we are on a path to pay $1 billion a day just in interest on the debt. That is how out of control it is getting.

Mr. BERNANKE. But our interest rates now are very low.

Mr. JORDAN. I understand that.

Mr. BERNANKE. So the concern would be that they would go higher, and then it would be much more difficult and disruptive to make the cuts and to make the changes you would have to make in the budget to meet the fiscal goals at that point with interest rates much higher.

Chairman SPRATT. Mr. Etheridge.

Mr. ETHERIDGE. Thank you, Mr. Chairman. Thank you for the hearing.

Mr. Chairman, thank you for being here. Thank you for your service.

Mr. BERNANKE. Thank you.

Mr. ETHERIDGE. I was here and I remember in 2008 when Congress didn't step up to the plate when we were requested to do so when the credit markets froze around the world and the stock market fell over 500 points in just a matter of minutes. And over the weekend, sounder heads prevailed, listened to good advice, and at least started back on the road. Not only were we punished, but a lot of folks in this country had money in 401(k)s and a host of other place. Some saw their life savings sink, and some lost them totally.

So thank you for your hard work and your efforts. And the economic collapse that was almost created by 8 years of not paying attention, squandering the surplus, and we just averted disaster, and I appreciate all those who did the work.

Your testimony notes and the economists on both sides of the political spectrums have pretty much agreed, I think, that thanks to the Recovery Act—and you testified to this earlier—we are starting to see signs of economic growth. You indicated earlier, some have indicated some of that growth may have been directly related, and in some States, depending on where they are, they say that as much as 2 percent loss in GDP in those areas.

Last week, I attended a school groundbreaking in Sanford, North Carolina. It was made possible from the recovery funds. And I think those are smart investments, not only to put people to work but lay the groundwork for long-term economic growth.

However, as you have indicated and testified, the recovery is still not on as sound footing as we would like for it to be. And my State of North Carolina still faces some tough times. Teachers, Medicaid funds that aren't funded. And those who take a pretty tough stance in saying, we ought not to do it. We shouldn't do it, because if we do it, there are those who will vote against it, who will go home and campaign against people who do what they consider the responsible thing and keep this economy moving forward, just for political purposes.

But my question for you, that we need to keep our eye on the ball, battling the fear, and my fear is that not only will children get hurt if we don't do the right thing, but economic recovery in the long run will pay a healthy price. In your view, what would be the effect on the recovery if we pull back too soon and do not provide the kind of aid that States may need at a very critical moment? And I think we are at that tender point right now. I would be interested in your thoughts on that.

Mr. BERNANKE. Let me first say that, in terms of any fiscal package, again, I don't want to adjudicate specific parts of it. And Congress needs to decide which components they want to support and which ones they think will be most effective.

But in terms of the time frame, right now I don't think is the time, this very moment is not the time to radically reduce our spending or raise our taxes because the economy is still in a recovery mode and needs that support.

However, the risk, of course, of ongoing deficits is the potential loss of confidence in the markets, and the way to reassure the markets is by creating a plausible plan for a medium-term stability in the fiscal situation. We, obviously, can't run deficits at 10 percent of GDP forever.

Mr. ETHERIDGE. And we put in PAYGO, as the chairman touched on earlier, to get that point.

You have outlined some of the Fed's action. And this may not be something you can deal with, but I think it is important to say at this meeting, because I have talked to a lot of community and small bankers, a lot of small business people, and a lot of developers who are really frustrated. They are frustrated because they see a need, they can do something; but because of certain regulations, they are being told that whatever the value of that real estate they had, if it was $500,000, it is now $300,000. And in many of them, they are cashing it in.

And I really fear if we aren't very cautious in what we do, we are going to wind up with a few large builders in this country, a few much bigger—more big banks, fewer community banks and fewer people to get involved in the local Lions Club, Boy Scouts and Girl Scouts and things that make America what America is. And as you sit with others, I hope you will remind them that it is these people. We have to make sure we get credit to our small business people in America. And that is not flowing yet, I don't think, in a way it needs to.

Mr. BERNANKE. I absolutely agree. I think there are some signs of progress, but it is still a tough situation. The Fed is a regulator as well as a monetary policymaker. We are working with our colleagues to do all we can to make sure that banks are making good loans.

Mr. ETHERIDGE. Thank you, sir.

Thank you, Mr. Chairman.

Chairman SPRATT. Mr. Djou, we welcome you to the committee again. I am pleased to recognize you for up to 5 minutes.

Mr. DJOU. Dr. Bernanke, a few quick questions.

My apologies. A freshman mistake here.

Dr. Bernanke, a few very quick questions here. First off, you begin in your testimony that the economy is showing modest signs of economic growth. I think we are all happy about that.

My question to you is, is that, given these signs of modest economic growth, do you believe that there is a need—is it wise to do additional fiscal stimulus to help the economy along? Or do you believe that the economy right now does not need further fiscal stimulus on the fiscal side?

Mr. BERNANKE. I will turn it back to you this way: If you decided to do more fiscal stimulus, and I know there are some moderatesized bills being contemplated, it would be very helpful to combine that with—again, I am reiterating this point, but again I think it is very important—with a plan for the fiscal exit strategy.

The Federal Reserve has a strategy for exiting from our monetary policy. The United States Government fiscal authorities have to have a strategy for exiting from your fiscal policy.

So you will have a more effective set of policies if you combine any expansions of further fiscal support with other measures that reassure markets that, in fact, our deficits will be controlled in the medium term.

Mr. DJOU. And do you right now see any exit strategy, fiscal exit strategy in the United States Congress?

Mr. BERNANKE. Well, we have the debt commission that Mr. Ryan is on and Mr. Spratt, and I hope that they will come up with some good recommendations. But right now, there is not anything on the table at this point.

Mr. DJOU. The second series of questions, Dr. Bernanke. And it is, I have been frustrated and disappointed that there have been a number of free trade agreements languishing in Congress. Do you believe that were the Congress to pass free trade or an expansion of free trade, it would help the economy?

Mr. BERNANKE. Yes, I do. I think we need to be a part of the globalized economy. I think trade is an important source of demand for our goods and also a source of materials and imports as well. So I think that, generally speaking, we ought to push forward on the Doha Round and on the free trade agreements that we are looking at.

Mr. DJOU. Finally, Dr. Bernanke, just sort of the last set of questions. You testified that the Federal budget, quote, appears to be on an unsustainable path. How will we know when it is on a sustainable path? What triggers, what earmarks, benchmarks would you guide the Congress on to know that we are on a sustainable path? Is there an amount that the budget deficit you think we should be looking at, a percentage of GDP to where the deficit should be at?

Mr. BERNANKE. One simple rule of thumb is that the primary deficit, which is the deficit excluding interest payments, should be about in balance. If that is true or, to put another way, that the deficit equals interest payments, so in practice, that might be at a 2 percent of GDP type deficit. If that is true, then arithmetically, with some other assumptions, it turns out that the ratio of the debt outstanding to the GDP remains constant. So I think keeping our debt relative to our income constant or declining would be a good indicator of sustainable policy.

Mr. DJOU. And to follow up on that, for this coming fiscal year, what number would that be for the budget deficit?

Mr. BERNANKE. Well, I don't think that there is any way that this deficit in this next year is going to be brought down to 2 percent, 2 or 3 percent. And, as I have been emphasizing, this is really a medium-term objective. We still have some time, but we need to get a plan in place as soon as we can.

Mr. DJOU. So what is the dollar amount, if the budget deficit is 2 percent of GDP?

Mr. BERNANKE. Well, right now, that would be about $300 billion.

Mr. DJOU. Thank you, Mr. Chairman.

Chairman SPRATT. Mr. Edwards.

Mr. EDWARDS. Dr. Bernanke, given your serious concerns about long-term structural deficits, critics might say that you are inconsistent in saying that you supported TARP and that the stimulus bill had positive effects. What would be your answer to those critics?

Mr. BERNANKE. My answer is that deficits are sometimes necessary. They are necessary in wartime. They are necessary in deep recessions, and this was the case where monetary policy was, you know, pushed very, very far. And I believe that the TARP—I realize it is very unpopular, but I do believe that it was very important in stabilizing our financial system. And indeed, the money has come back for the most part. So for those emergency purposes, I think the deficits were necessary. That being said——

Mr. EDWARDS. And the TARP and the stimulus were necessary in your opinion?

Mr. BERNANKE. I believe they were very helpful, yes. TARP in particular prevented a breakdown of the global financial markets, the global financial system. But that being said, you know, we can't have an emergency every year. We have to maintain a more stable situation over the longer term.

Mr. EDWARDS. I understand. But I think, just to clarify, you just said that without TARP, we could have had a breakdown in the world financial system, is that correct?

Mr. BERNANKE. I think without a doubt we would have.

Mr. EDWARDS. Okay. So, in effect, you think TARP, the passage of TARP was consistent with the principle fiscal responsibility?

Mr. BERNANKE. I do because in the absence of TARP, we would have had a much deeper recession, and the losses of tax revenue and the other costs would have far outweighed the actual costs of the TARP.

Mr. EDWARDS. So what you are saying then is, without TARP, we could have actually had larger deficits and a greater national debt than we have today?

Mr. BERNANKE. We almost certainly would have.

Mr. EDWARDS. And there is at least a probability we could have had a second Great Depression?

Mr. BERNANKE. I think so, yes.

Mr. EDWARDS. Okay. Also before we make decisions about the future, we need to be sure we understand what happened in the past.

Could someone bring up Mr. Garrett's chart, please?

Now this chart doesn't talk about 2003, 2002, 2001. Do I understand, when President Bush came into office, that the gray deficit areas during his administration were actually projected to be a total of $4 trillion to $5 trillion in surpluses, is that correct, when President Bush walked into office?

Mr. BERNANKE. The 10-year projections were something like that.

Mr. EDWARDS. Okay. And then, when we go to 2009, it looks like to me about a $1.4 trillion deficit in 2009, the first year of the Obama administration. Am I not correct in understanding that $1.3

trillion of that was projected before President Obama was sworn into office? So about 93 percent of that first red column for 2009 was projected before President Obama signed a single bill into law, is that about correct?

Mr. BERNANKE. As of when, as of 2009?

Mr. EDWARDS. As of the—while President Bush was still in office, weren't there projections for 2009 to be a $1.3 trillion deficit?

Mr. BERNANKE. I don't remember the exact number. But clearly, most of that deficit was the result of the recession and the financial crisis, which in late 2008, we already knew about it.

Mr. EDWARDS. Right. And I think CBO projected a $1.3 trillion deficit before President Obama was sworn into office.

Let me ask you, Dr. Orszag, the director of OMB, has said that the 2001 and 2003 tax cuts and the Medicare prescription drug bill, all unpaid for and passed by Republicans on a virtually partisan basis will, have added $6 trillion to the national debt over the next decade. Do you have any figures that would substantially differ from Dr. Orszag's testimony on how those three bills added to the national debt?

Mr. BERNANKE. I don't have any figures, but I know that they calculate on a baseline basis, but you know those numbers would be pretty big I think.

Mr. EDWARDS. Okay. As we go forward, would making permanent all of the Bush 2001 and 2003 tax cuts reduce the national debt or increase the national debt?

Mr. BERNANKE. If you did absolutely nothing else, it would increase it because it might make the economy grow faster but probably not fast enough to make up the revenue loss.

Mr. EDWARDS. So in and of themselves, extending those tax cuts and making them permanent would increase the national debt, is that correct?

Mr. BERNANKE. Yes, it would. But there is also the trade-off. You have to ask yourself whether there are other options that might be more effective at reducing the deficit at less cost.

Mr. EDWARDS. I understand. I understand the timing of the changes in tax law is important. But in your opinion, do tax cuts pay for themselves? Some people say you can balance the budget by just cutting taxes more. In your opinion, do tax cuts pay for themselves?

Mr. BERNANKE. In general, say income tax cuts, the actual revenue loss is less than the static estimate because there is some positive response in the economy. But in general, I don't think most economists would agree that they completely pay for themselves, no.

Mr. EDWARDS. Okay. Thank you.

Chairman SPRATT. The $1.2 trillion estimate of the surplus deficit for 2009 was a number supplied by CBO in its outlook of the budget and the economy for 2009, 2010, 5 years to come.

Mr. Austria of Ohio.

Mr. AUSTRIA. Thank you, Mr. Chairman.

And Dr. Bernanke, thank you for being here today and sharing your thoughts on the economy and the financial markets. And certainly I appreciate you sharing your thoughts about needing a system that is more resilient and having a plan in place for stabilization. And I appreciate the Federal Reserve being cautious about the U.S. economic outlook.

Although you have also noted that there has been some recovery and it looks as though there might be modest recovery over the next couple of years, but I think there is also a growing risk out there that the economy could be dampened or even undercut by the ripple effects of the debt crisis in Europe right now, what is happening in Europe.

And also, when you combine that with the concerns that I am hearing out there, from our small businesses, the concerns about getting the necessary financing, the necessary credit to continue their operations and wanting to expand their operations and businesses, the concerns about the consistently high rates of unemployment that we have right now and underemployment and the lack of private jobs that are being created right now that I believe are the long-term sustainable jobs that will turn this economy around.

When you combine that with the massive government spending and debt, all those being a major threat to sustainable growth, I wanted to get your views on the spending and debt control, on the uncertainty that is bringing to our economy right now and the direction that you think that we are moving and whether or not—you know, I think there is a fundamental difference here on the types of jobs that are being created with all this, government jobs versus the private sector jobs.

Mr. BERNANKE. Well, first of all you did a good job of identifying some of the risks to the recovery: Financial market risks, small business credit, and unemployment. Those are some of the things that I have highlighted in speeches and discussions. As I have indicated, I think, once again, that we need to think about our fiscal path, our fiscal plan as a trajectory, not as a single year-by-year deficit. It is not realistic, I think, to—or even advisable to try to balance the budget this year because that would be too wrenching a change, and the economy is still in weak condition, and I don't think that would be possible or advisable.

However, in order to maintain the confidence of the markets and to keep interest rates low, which is very useful for the whole economy and for the recovery, it is also very important to try to provide reassurance through some mechanism that Congress is seriously contemplating measures that will bring us back to sustainability over the medium term. I realize that is a difficult thing to do and it is difficult to be credible. But Congress is very creative on these types of matters and I hope that you will be looking at ways to find the path back to sustainability over the next few years.

Mr. AUSTRIA. And if we can bring up a figure. I am looking at chart number one. I believe that is the chart on the Tidal Wave of Debt right there. This chart right here. I wanted to get your opinion as far as the debt crisis that we are seeing across Europe right now. You know, how this could occur in the U.S. if we don't change the way we are going right now. You know, there are projections right now that payments are projected to reach 20 percent of the tax revenue or higher by 2020, as far as our payments continue to grow. And when you look at this chart, I wanted to get your thoughts on that.

Mr. BERNANKE. Well, this chart just illustrates graphically what I have been saying, which is when the red line is sloping upwards so sharply, that is just a graphical way of saying that it is not sustainable. You want a situation where that gray-red line is sort of flat or going down instead of rising.

Mr. AUSTRIA. And let me go back now in combining this debt with what I am hearing from our small businesses out there who are struggling right now. As far as bringing more certainty to the markets, as far as creating jobs within the private sector, do you believe, when we continue to spend the way we are, continuing to grow government, at that—at some point—at what point do we start to create the jobs in the private sector? I guess is my question.

Mr. BERNANKE. Well, as I said, I think at this point—I mean putting aside the Census, I think the private sector is starting to come back. We are starting to see growth for consumers for example and that will drive private sector job creation. We anticipate private sector job creation between 150,000, 250,000 jobs, something like that going forward, not enough to get back all the jobs that we have lost but is still significant. So I think you know we are on a path of moderate recovery, but we want to have as much resolution of uncertainty as possible to encourage businesses to expand and to hire.

Chairman SPRATT. Ms. Kaptur.

Ms. KAPTUR. Thank you, Mr. Chairman. Got to get the equipment to work.

Welcome. Thank you for the work you are doing. Thank you for the efforts that the Cleveland Fed is making. Ohio is in more than a recession. When you have 40 to 60 percent of home loans under water, the future is very, very troubled.

Therefore, I have two requests for data for the record and two small questions. The first request for data is, can you please ask the economists on your staff to supply our committee with an estimate of the total direct and indirect real costs to our economy through mid-2010 of the financial bailout as well as tax dollars that may be at risk into the future?

In order to help give them bookends for that effort, we will provide to the record a study done by the Congressional Research Service in that regard where a figure is given of $14.4 trillion, and the Pew Financial Reform Project has indicated that U.S. households lost on average $5,800 in income due to reduced economic growth due to the financial crisis through the end of 2009 and that the cost to the Federal Government, due to interventions to mitigate the financial crisis, amounted to over $2,000 on average for each U.S. household. The Pew study shows that home values have fallen about $30,300 per household; stock values, about $66,000 on average. We know what the job loss has been, and that is not getting much better in my part of the country.

So I wanted to submit these for the record. You know, you have terrific economists over there, and I think if you could tell us the cost of this, it would be very helpful to those of us in the positions that we hold.

[The information follows:]

Congressional Research Service

MEMORANDUM April 16, 2010

To: Honorable Marcy Kaptur
Attention: Deborah Koolbeck

From: Baird Webel, Specialist in Financial Economics, x7-70652

Subject: **Assessment of Government Financial Interventions**

This memorandum responds to your request for an update and assessment of the "real size of the bailout" as published by *Mother Jones*.[1] The article that you supplied estimates this "real size" at $14.4 trillion as of October 29, 2009. The following will give a brief analysis of the figures involved in this $14.4 trillion estimate and updates the programs identified in this article with current values. Attached is a recent CRS Report, R41073 *Government Interventions in Response to Financial Turmoil*, by Baird Webel and Marc Labonte, which assesses the various programs in detail.

The $14.4 trillion estimate is one example of many that have been reported in the news. Such news sources typically have referred to "potential cost to taxpayers," "amount taxpayers are on the hook for," or "taxpayer exposure" as a result of the financial crisis with amounts reaching as high as $23.7 trillion.[2] Such calculations have relatively limited meaning if the goal is to accurately assess the government's financial interventions in the recent crisis. A common shortcoming in this regard is that they conflate actions, such as purchasing assets, guaranteeing assets, and outright spending, that are different in terms of the impact on the government budget or on private markets. Headline totals are typically reached by calculating the maximum theoretical size of programs or by using the total size of markets being assisted with little indication as to whether such totals might be reached. Experience so far has been that outlays for most programs have been far smaller than various reported potential sizes.

One example of this is that the supplied chart assesses the Federal Reserve's Commercial Paper Funding Facility (CPFF) at $1,800 billion. This figure is the sum of all the commercial paper that might be eligible under the program, however, the Federal Reserve retained the discretionary authority to reject applicants to the CPFF and has not indicated the intention to purchase $1.8 trillion worth of this paper. The actual maximum size of the CPFF was $351 billion in January 2009, and the program expired on February 1, 2010. Another example is the Money Market Mutual Fund, assessed on the chart at $3,757 billion. This figure may represent an estimated size of all of the money market mutual funds that were guaranteed under the Treasury's program, however, these money market mutual funds are backed by various financial assets, including U.S. Treasury and corporate securities. Scenarios in which these assets

[1] http://motherjones.com/politics/2010/01/real-size-bailout-treasury-fed.

[2] See, for example, Dawn Kopecki and Catherine Dodge, "U.S. Rescue May Reach $23.7 Trillion, Barofsky Says," *Bloomberg News*, July 20, 2009, http://www.bloomberg.com/apps/news?pid=20601087&sid=aY0tX8UysIaM; "Potential Cost of U.S. Financial Bailout: Over $8 Trillion," *CNBC.com*, November 25, 2008, http://www.cnbc.com/id/27912307.

fall to zero value, thus necessitating payment by the government of $3,575 billion are therefore unrealistic. The single money market mutual fund that failed in September 2008 still returned more than 98% of its outstanding value to fund holders.

The $14.4 trillion estimate includes some instances of double counting, where funds are either counted both within the general program and the specific recipient or funding for the same purpose at two different times is counted both times. For example, in the AIG intervention, the calculation includes $53 billion for Maiden Lanes II and III, and also $38 billion for the AIG securities lending facility. Maiden Lane II, however, was specifically designed to replace the securities lending facility and the facility was closed when Maiden Lane II was created. Another example is the "$138 billion JPMorgan Chase/Lehman Bros." loan. This amount was two different short-term loans, one of which was paid back before the second was made. Both were part of the Primary Dealer Credit Facility, which is also totaled up separately in calculating the $14.4 trillion figure. The inclusion of both the "TARP overpayment," which is actually the losses that CBO expects TARP to incur, as well as the overall figure for TARP is another example of double counting.

The $14.4 trillion estimate also contains some factual errors. For example, it reports a $301 billion figure as the amount for the Citigroup asset guarantee. While the federal guarantee was on a $301 billion pool of assets, the structure of the guarantee was such that some of these losses would be borne by Citigroup, not by the government. A similar mistake was made on with the Bank of America guarantee figure, a guarantee which was never actually finalized. Both guarantees were also partly funded through TARP and thus another example of double counting. It appears as well that the actual sum of the figures in the report is somewhat under $14.3 trillion, rather than $14.4 trillion.

Table 1 and Table 2 below contain the amounts reported by *Mother Jones* along with the current actual size in cases where CRS was able to identify a current size. The programs that have expired or are no longer taking on new commitments are shaded. Some of the programs, however, do have outstanding balances and these figures are included in the tables. Bolded figures have aspects of double counting, although in some cases the entire amounts are not counted twice.

Table 1. Department of the Treasury Programs

(all figures in billions of $)

Program	Reported Size (Oct 2009)	Current Actual Size (April 2010)
MMMF	**$3,757**	$0
PPIP	**$1,000**	**$8**
TARP	**$578 ($78 repaid)**	**$380 ($181 repaid)**
GSE Stock Purchase	$400	$126
GSE MBS Purchase	$314	$221
Citigroup Asset Guarantee	**$301**	$0
T-Bill Auctions to fund Fed	**$260**	**$150**
TARP Overpayment	**$159**	**$109**
Bank of America Asset Guarantee	**$118**	Not Applicable
Potential International Fund liabilities	$100	Unable to Identify current size.
HAMP	**$50**	**$0.1**
Exchange Stabilization Fund	**$50**	$0
GSE Credit Facility	$25	$0
Total	$7,112	$727

Source: *Mother Jones*, U.S. Treasury, Federal Housing Finance Agency

Notes: Shaded programs are expired or are no longer taking new commitments. Bold figures have elements of double counting. Total for Current Actual Size does not include amounts that were double counted in the first estimate. The contract for the Bank of America asset guarantee was never finalized and signed.

Table 2. Federal Reserve Programs

(all figures in billions of $)

Program	Reported Size (Oct. 2009)	Current Actual Size (April 2010)
CPFF	$1,800	$8
MBS purchase	$1,250	$1.102
TALF	**$1,000**	**$47**
Foreign Central Bank Swaps	$755	$0
Money Market Investor Funding Facility	$540	$0

Program	Reported Size (Oct. 2009)	Current Actual Size (April 2010)
Treasury Purchase Program	$300	$300
GSE Program	$200	$169
ABCP/MMMF liquidity facility	$146	$0
Primary Dealer Credit	**$148**	$0
JPMorgan Chase/Lehman Bros	**$138**	$0
Open Market Operations	$125	$0
Tri-party Repurchase Agreement	$125	$0
Primary Credit	$112	$0
Temporary Reserves	$93	$0
Single Tranche Repurchase agreements	$80	$0
Term Auction Facility	$75	$0
TOP	$50	$0
Maiden Lane II&III(AIG)	**$53**	$32
AIG preferred stock interests, credit, and loan	$60	$51
AIG securities Lending	**$38**	$0
Open Market account securities lending	$36	$0
Maiden Lane I (Bear Stearns)	**$30**	$29
TSLF	25	$0
JPMorgan/Bear Stearns Loan	**$13**	$0
Total	$7,192	$1,738

Source: *Mother Jones*, Federal Reserve

Notes: Shaded programs are expired or are no longer taking new commitments. Bolded figures have elements of double counting. Total for Current Actual Size does not include amounts that were double counted in the first estimate.

THE COST OF THE FINANCIAL CRISIS: THE IMPACT OF THE SEPTEMBER 2008 ECONOMIC COLLAPSE

BY PHILLIP SWAGEL[1]

The United States pulled back from a financial market meltdown and economic collapse in late 2008 and early 2009—but just barely. Not until we came to the edge

---

[1] Phillip L. Swagel is visiting professor at the McDonough School of Business at Georgetown University, and director of the school's Center for Financial Institutions, Policy, and Govern-

Continued

of catastrophe were decisive actions taken to address problems that had been building in financial markets for years. By then it was too late to avert a severe recession accompanied by massive job losses, skyrocketing unemployment, lower wages, and a growing number of American families at risk of foreclosure and poverty.

This paper quantifies the economic and budgetary costs resulting from the acute stage of the financial crisis reached in September 2008. This is important on its own, but it can be seen as well as giving a rough indication of the potential value of reforms that would help avoid a future crisis.

On a budgetary level, the cost of the stage of the crisis reached in mid-September 2008 is the net cost to taxpayers of the policies used to stem the crisis. This includes the programs undertaken as part of the

Troubled Assets Relief Program (TARP), as well as steps taken by the Federal Reserve and the Federal Deposit Insurance Corporation (FDIC) to guarantee bank liabilities. Actions to support Bear Stearns and the two government-sponsored entities, Fannie Mae and Freddie Mac, were taken before the worst part of the crisis, but their costs continued past September and are considered by many to be part of the fiscal costs of the crisis.

The costs of the crisis to society, however, go beyond the direct fiscal impacts to include the effect on incomes, wages, and job creation for the U.S. economy as a whole. The crisis reduced U.S. economic growth and caused a weaker job market and other undesirable outcomes. A key challenge in quantifying such a macroeconomic view of the costs of the financial crisis is to identify the particular effects of the crisis and to separate those impacts from other developments.

The broadest perspective would look at the overall changes in the economy from the start of the crisis to the end, and perhaps even include an estimate of the long-run future impacts. Implicit in such a calculation would be a decision to include both the effects of the crisis itself and any offsetting impacts from policy responses such as easier monetary policy or fiscal stimulus. A broad accounting of the costs of the crisis could also include the decline in government revenues resulting from the crisis, enactment of policies such as the 2008 and 2009 stimulus packages, as well as the impacts of regulatory changes that came about in the wake of the crisis. Under such a view, the financial crisis had large and long-lasting impacts on the U.S. economy. The Organisation for Economic Co-operation and Development (OECD), for example, estimates that the financial crisis will lead to a 2.4 percent reduction in long-term U.S. GDP, anticipating that both the reduction in employment and the increased cost of capital resulting from the crisis will last far into the future.[2]

The approach taken in this paper is narrower: to distinguish and quantify costs incurred so far that are directly related to the crisis and, in particular, to focus on the impact of events from the collapse of Lehman Brothers in the middle of September 2008 through the end of 2009. This is the period in which the grinding slowdown associated with the credit disruption that began in August 2007 turned into a sharp downturn. This approach produces smaller estimates for the cost of the crisis than the broad view, because the calculations quantify the costs of the acute phase of the crisis between September 2008 and the end of 2009, and not the overall impact of events both preceding and following that time period. Both approaches are valuable, and this paper is best seen as a complement to the literature on the overall cost of financial crises. This distinction is revisited in the conclusion.

The results in this paper complement economic research by Reinhart and Rogoff (2009) that assesses the broad overall costs of banking crises across countries.[3] Reinhart and Rogoff find that deep economic downturns "invariably" follow in the wake of crises; they quantify the average impact across countries on output, asset prices, the labor market, and government finances. Their results are also discussed below.

The cost of the crisis as measured here includes both the fiscal cost and the effects on economic measures such as output, employment, wages, and wealth. The difficulty in quantifying these economic impacts is to isolate the effects of the most acute stage of the crisis—the severe downturn in consumer and business spending that took place following the failure of Lehman Brothers in September 2008. The U.S. economy was already moving sideways in the first half of 2008 and most forecasters expected slow growth to continue for the balance of the year and into 2009.

---

ance. This paper was prepared for, and initial results were presented at, the March 18, 2010 public event, "Financial Reform: Too Important to Fail," sponsored by the Pew Financial Reform Project.

[2] OECD, 2010. Going for Growth, Chapter 1, Box 1.1, pp. 18-19, March.

[3] Carmen M. Reinhart and Kenneth S. Rogoff, 2009. "The Aftermath of Financial Crises," American Economic Review, vol. 99(2), pages 466-72, May.

But the events of the fall and the plunge in economic activity that resulted were unexpected.

This paper isolates the impact of the acute phase of the crisis by comparing the Congressional Budget Office (CBO) economic forecast made in September 2008, just before the crisis, with actual outcomes. The approach is to compute the difference between the decline in GDP in late 2008 and 2009 and the forecast published by CBO in its "Budget and Economic Outlook: An Update," published on September 9, 2008—the Tuesday before Lehman filed for bankruptcy on Monday, September 15. The difference between actual GDP in the five quarters from October 2008 to December 2009 and the CBO forecast made just on the cusp of the crisis is taken as the unexpected impact of the crisis on GDP. This GDP impact is then used to calculate the impact of the crisis on other measures, including jobs, wages, and the number of foreclosures. The accuracy of CBO economic forecasts is similar to that of the Blue Chip consensus.[4]

While this approach works to isolate the impacts of events from September 2008 forward, it is necessarily imprecise because it is impossible to know a) how accurate the CBO forecast would have been absent the crisis; b) whether the relationships between growth and other economic variables such as employment changed during the crisis; and c) the impact of other events from September 2008 forward that are not related to the crisis. Moreover, the calculations in the paper start with the fourth quarter of 2008 and thus do not attribute to the crisis any output or jobs that were lost in the two weeks of September immediately following the collapse of Lehman Brothers (these are still counted and appear in the charts below, but not as part of the cost of the post-Lehman crisis). The results in the paper should thus be taken as providing a rough approximation of the impact of the crisis. This is hugely meaningful, however, with American families suffering thousands of dollars of losses in incomes and wages and enormous declines in the value of their assets, including both financial assets, such as stock holdings, and real estate properties, such as family homes. These losses run into the trillions of dollars and on average come to a decline of nearly $66,000 per household in the value of stock holdings and a loss of more than $30,000 per household in the value of real estate wealth (though the inequality in wealth holdings means that the losses will vary considerably across families). These impacts on incomes, jobs, and wealth are all very real effects of the crisis.

Finally, the paper looks briefly at broader impacts on society, notably the effect of the crisis in boosting foreclosures and potential impacts on human factors such as poverty.

DIRECT COSTS TO TAXPAYERS OF FINANCIAL INTERVENTIONS

A host of government interventions were aimed at stabilizing banks and other financial sector firms, ranging from loans from the Federal Reserve to the outright injection of public capital into banks through the Treasury's Troubled Assets Relief Program (TARP). The direct budgetary cost of the crisis is taken to equal the expected net losses of these programs. The fiscal impact of the crisis considered here does not include the lower revenues and increased government spending that followed the crisis. Instead, the focus is on the costs of interventions undertaken in direct response to the acute phase of the crisis that began in September 2008, notably the cost of the TARP and related programs to guarantee bank liabilities put into effect by the Federal Reserve (Fed) and the Federal Deposit Insurance Corporation (FDIC). These costs are tallied in Tables 1 and 2, below. These cost estimates are from the January 2010 CBO estimate of TARP commitments and expected losses, and the February 2010 estimate by the Congressional Oversight Panel of the Fed's commitment to several programs run jointly by the Treasury and the Fed (the table provides references to the sources). The TARP authority was part of the Emergency Economic Stabilization Act of 2008 (EESA) enacted on October 3, 2008; this was used by the Treasury Department for a variety of purposes, including capital injections into banks, guarantees for assets of certain banks, foreclosure relief, support for the AIG insurance company, and subsidies to prevent foreclosures.

CBO estimates that $500 billion of the $700 billion capacity of the TARP will end up being used or committed, with programs now in existence having a $73 billion net cost to taxpayers. As shown in Table 1, the TARP was used to support a range of activities, including the purchase of stakes in banks under the capital purchase program (CPP); special assistance to Citigroup, Bank of America, and AIG; support to automotive industry firms; support for programs to boost securitization of new lending through the Term Asset-Backed Securities Loan Facility (TALF) run jointly

[4] Congressional Budget Office, 2006. "CBO's Economic Forecasting Record," November 2006.

with the Fed; the Public-Private Investment Partnerships (PPIP) to deal with illiquid "legacy" assets such as subprime mortgage-backed securities; and the Home Affordable Program aimed at reducing the number of foreclosures. TARP assistance to banks on the whole is projected to generate a $7 billion profit for taxpayers (even though some banks that received TARP funds have failed or stopped paying dividends to the Treasury). Other programs, notably aid to auto firms, AIG, and homeowners at risk of foreclosure, are projected to result in substantial losses of TARP funds, with an overall net cost of $73 billion. As part of the Congressional budget process, the CBO estimates as well that there could be future uses and losses involving TARP resources, but they would not be directly related to the crisis of September 2008.

In addition, the Federal Reserve lent $248 billion as part of TARP-related programs to support AIG and to foster securitization through the TALF. These Fed loans are generally well-secured—indeed, Fed lending related to AIG is now overcollateralized (the TARP having replaced the Fed in the risky aspect of the AIG transaction)—but it is possible in principle that there could be future losses and thus further costs.

TABLE 1: DIRECT COSTS OF THE TARP
($ BILLIONS)

	Distributed or Committed by Treasury	Net Cost (profit if negative)	Federal Reserve Commitment
Total TARP	**501**	**73**	**248**
CPP (Bank capital)	205	-3	
Citigroup	25	-2	
Bank of America	20	-2	
AIG	70	9	68†
Autos	81	47	
TALF (Securitization)	20	1	180
PPIP (Illiquid MBS)	30	3	
HAMP (Foreclosures)	50	20	

Sources: Congressional Budget Office, "The Budget and Economic Outlook: Fiscal Years 2010 to 2020," January 2010, Box 1-2, pp. 12-13, and TARP Congressional Oversight Panel "February Oversight Report," February 10, 2010, pp. 176-177. Treasury commitments and costs or profits are from the Congressional Budget Office; Federal Reserve commitments as of December 31, 2009 are from the Congressional Oversight Panel February 2010 report.

† The $68 billion reported by the Congressional Oversight Panel represents the amount of AIG-lending extended by the Federal Reserve, but not the net cost of this lending. The Federal Reserve Bank of New York reports that the outstanding balance of Federal Reserve lending related to AIG as of September 30, 2009 totaled $36.7 billion with a fair market value of $39.7 billion for the collateral behind the lending, implying that the lending is overcollateralized on a mark-to-market basis. In effect, resources from the TARP replaced part of the initial Fed lending to AIG, leaving the TARP with losses and the Fed's remaining loans over-collateralized.

Table 2 also shows certain direct budgetary costs related to the crisis that commenced before September 2008, notably Federal Reserve lending related to the collapse of Bear Stearns in March 2008, and cost to the Treasury of support for the two housing-related GSEs, Fannie Mae and Freddie Mac. These are not directly the result of the September 2008 stage of the crisis, but are shown since they are closely related to those financial market events. The financial rescue of Fannie Mae and Freddie Mac cost taxpayers $91 billion in fiscal year 2009 (October 2008 to September 2009), according to the Congressional Budget Office, and CBO forecasts a total cost to taxpayers of $157 billion through 2015 (these figures are from Table 3-3 in the CBO January 2010 Budget and Economic Outlook). These costs are related to the broader financial crisis, since the activities of the two firms underpinned parts of the housing market that were at the root of the crisis. There is a sense, however, that these costs were the result of losses that largely predated the events of September 2008—namely losses on mortgages guaranteed by the two firms, and losses on subprime mortgage-backed securities they purchased prior to the failure of Lehman Brothers. While the costs grew as a result of the September 2008 crisis and the subsequent economic collapse, it is likely that much of the losses were built into these firms' balance sheets before September 2008. As shown in Table 2, Fed lending related to Bear Stearns involves a loss of $3 billion on a mark-to-market basis—this is the net of the $29 billion in non-recourse lending from the Fed minus the estimated value of the collateral behind those loans as of September 30, 2009 (the most recent date for which estimates are available).

TABLE 2: OTHER FINANCIAL COMMITMENTS RELATED TO THE CRISIS
($ BILLIONS)

Agency	Type of Commitment or Assets Purchased	Amount guaranteed or purchased
FDIC	TLGP (guarantees for bank debt)	577
Federal Reserve	GSE debt purchases	175
	Mortgage-backed securities purchases	1,250
	Treasury securities purchases	300
	Bear Stearns-related lending	29†
Treasury	GSEs – Support for Fannie Mae and Freddie Mac	157

Sources: FDIC: TARP Congressional Oversight Panel "February Oversight Report," February 10, 2010, pp. 176-177. FDIC Temporary Loan Guarantee Program is the amount of senior bank debt covered by FDIC guarantees. Federal Reserve purchases are from www.federalreserve.gov/monetarypolicy. These figures are total (gross) amounts of liabilities guaranteed by the FDIC and assets purchased by the Federal Reserve; they do not provide the net cost or gain to taxpayers. The FDIC and Federal Reserve programs are all likely to make positive returns. Treasury costs for GSEs are from Congressional Budget Office, "The Budget and Economic Outlook: Fiscal Years 2010 to 2020," January 2010, Box 3-3, p. 52.

† The Federal Reserve Bank of New York reports a fair market value of $26.1 billion for the collateral behind the $29.2 billion loan balance related to Bear Stearns as of September 30, 2009, implying a $3 billion loss on a mark-to-market basis.

Other monetary policy actions undertaken by the Federal Reserve in the fall of 2008, such as programs to support commercial paper markets and money market mutual funds, are not included in this tally. These might well have positive budgetary impacts as the Fed collects interest and fees from users of these liquidity facilities. Similarly, the stimulus packages enacted in early 2008 and early 2009 were both arguably brought about because of the impact of the financial crisis on the economy, but these did not directly address financial sector issues and are not included here.

In sum, the direct budget costs from efforts to stabilize the financial system following the events of mid-September 2008 are meaningful—with net costs of $73 billion and hundreds of billions of public dollars deployed or otherwise put at risk of loss. These figures, however, are only a modest part of the cost of the financial crisis. The larger impacts are those that affected the private sector as a result of the significant decline in economic activity that followed the crisis. These are tallied by calculating the impact of the September 2008 financial crisis on output, employment, wages, and wealth.

ECONOMIC COSTS: LOST WAGES, INCOMES, JOBS, AND WEALTH

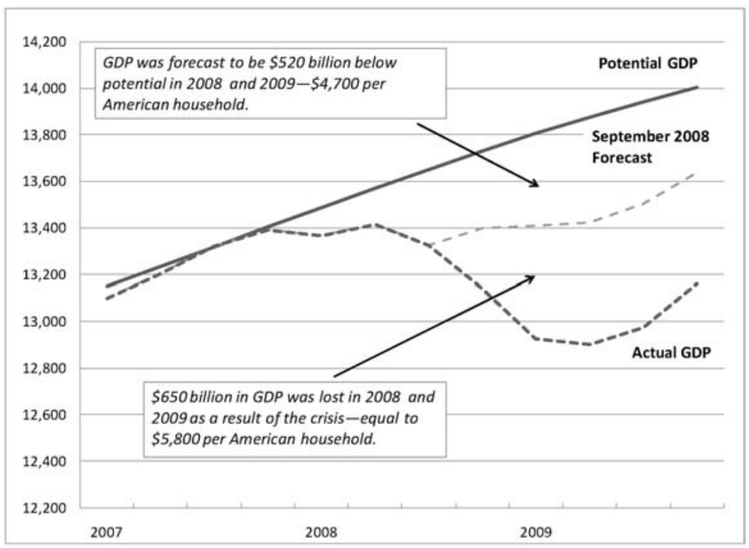
The U.S. economy was already slowing in the first half of 2008, as the slide in housing prices that began in 2006 and the tightening of credit markets from 2007 both weighed on growth. High oil prices added another headwind in 2008. The economy entered a recession in December 2007; while this was not yet announced when the crisis became acute in mid-September 2008, it was clear that growth would remain subdued even under the best of circumstances while the U.S. economy worked through the challenges of housing, credit, and energy markets. Even so, the financial crisis in September 2008 clearly exacerbated the pre-existing economic slowdown, turning a mild downturn into a deep recession. In effect, the events of September and October 2008 were a severe negative shock to American confidence in the economy, and in the ability of our government and our political system to deal with the crisis. All at once, families and businesses across the United States looked at the crisis and stopped spending—even those who had not yet been directly affected by the mounting credit disruption that started in August 2007 put a hold on their plans. Families stopped spending, while firms stopped hiring and paused investment projects. As a result, the economy plunged, with GDP falling by 5.4 percent and 6.4 percent (at annual rates) in the last quarter of 2008 and the first quarter of 2009—the worst six months for economic growth since 1958.

Assessing the economic costs associated with the acute phase of the crisis in September 2008 requires separating the impacts of the events of fall 2008 from the pre-existing economic weakness. While this is not possible to do with precision, one practical approach is to take as a baseline the GDP growth forecast published by the CBO on September 9, 2008—just before the crisis. The difference between actual GDP, and the CBO forecast for GDP in the balance of 2008 and over all of 2009, is then taken to reflect the "surprise" impact of the crisis. This is an imperfect measure since there is no reason to expect the CBO forecast to have been completely accurate had it not been for subsequent events such as the collapse of Lehman.

With these caveats in mind, the September 2008 CBO forecast remains plausible as a guide for what would have happened absent the financial crisis of September 2008. The CBO forecast 1.5 percent real GDP growth in 2008 as a whole, followed by 1.1 percent growth in 2009. With the first half of the year already recorded, 1.5 percent growth for the year as a whole implies that CBO expected GDP to decline at a 0.25 percent annual rate in the second half of 2008.[5] That is, CBO expected growth to be weak and even slightly negative in the latter part of 2008 but then pick up in 2009—indeed, the CBO forecast implies quite strong growth by the end of 2009.

Figure 1 plots actual real GDP against GDP as implied by the CBO forecast from September 2008 and the CBO's calculation of potential GDP—the level of GDP that would be consistent with full utilization of resources.[6] As shown on the chart, GDP plunged at the end of 2008 and into early 2009, falling by 5.4 percent and 6.4 percent in the last quarter of 2008 and the first quarter of 2009, against CBO expectations of a nearly flat profile for output over this period. The difference between the CBO forecast and the actual outcome for GDP comes to a total of $648 billion in 2009 dollars for the five quarters from the beginning of October 2008 to the end of December 2009, equal to an average of $5,800 in lost income for each of the roughly 111 million U.S. households.

FIGURE 1: IMPACT OF THE CRISIS ON ECONOMY-WIDE OUTPUT



Note: GDP as plotted in the chart is in billions of 2005 (real) dollars at a seasonally adjusted annual rate. The dollar figures in the boxes, however, are translated into 2009 dollars.

The hit to GDP was matched as well across the economy, with declines in jobs, wages, and wealth. The next step is to translate the unexpected GDP decline into an impact on the labor market. To calculate the impact on employment, a statistical relationship is estimated between percent job growth in a quarter and real GDP growth over the past year. The four-quarter change in output is used to capture the fact that the job market is typically a lagging indicator, responding after some delay to an improving or slowing overall economy. The relationship is estimated as a linear regression for quarterly data from 2000 to 2007, capturing a complete business cycle. This regression provides an empirical relationship between GDP growth and

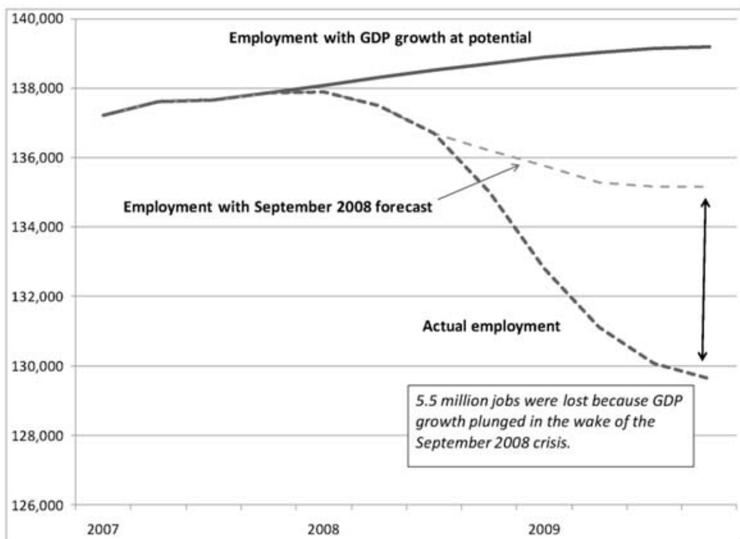
[5] GDP data for 2008 have been revised since the CBO forecast was made; the implied negative GDP growth of 0.25 percent at an annual rate is computed using the GDP data that were available to the CBO in September 2008.

[6] The CBO forecast uses the growth rates in the September 2008 CBO forecast, adjusting the past levels of GDP for subsequent revisions to GDP data that were known prior to September 2008.

job growth—an analogue of what economists term "Okun's Law." The estimated regression is not a structural model, but an empirical relationship that can be used to back out employment under different GDP growth scenarios. The GDP figures corresponding to the CBO forecast are then used to simulate the level of employment that would have occurred with the CBO forecast made before the September 2008 crisis.

Figure 2 shows the impact of the acute stage of the crisis on employment: 5.5 million jobs were lost in the five quarters through the end of 2009 as a result of slower GDP growth compared to what would have been the case under the CBO forecast made in September 2008. Slow growth in the first three quarters of 2008 had left employment 1.8 million jobs lower than potential, and the CBO forecast for continued weak growth in the rest of 2008 and 2009 would have meant job losses until the last quarter of 2009, but at a much more moderate pace than actually occurred. Under the CBO forecast, employment by the end of 2009 would have been 4.0 million lower than with growth at potential, but the additional negative shock to GDP from the crisis knocked off another 5.5 million jobs, leaving employment at the end of 2009 9.5 million jobs lower than the potential of the U.S. economy.

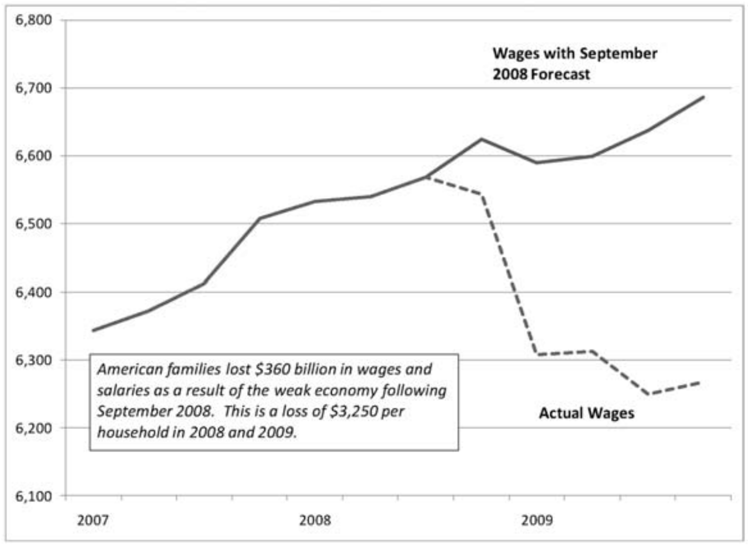
FIGURE 2: IMPACT OF THE CRISIS ON EMPLOYMENT



Note: Employment in thousands.

Figure 3 shows that the GDP hit and job losses correspond to lost wages for American families—a total of $360 billion of lost wages in the five quarters from October 2008 through December 2009 as a result of slower growth following September 2008. This equals $3,250 on average per U.S. household. Wage losses are calculated by taking actual wages with the lower growth and adding back both the wages for the jobs that would have existed with stronger growth and the increased wages per job for all jobs had growth not plunged in the fall and dragged down average wages. The additional wage growth per job is calculated using the trend wage growth before the crisis.

FIGURE 3: IMPACT OF THE CRISIS ON WAGES

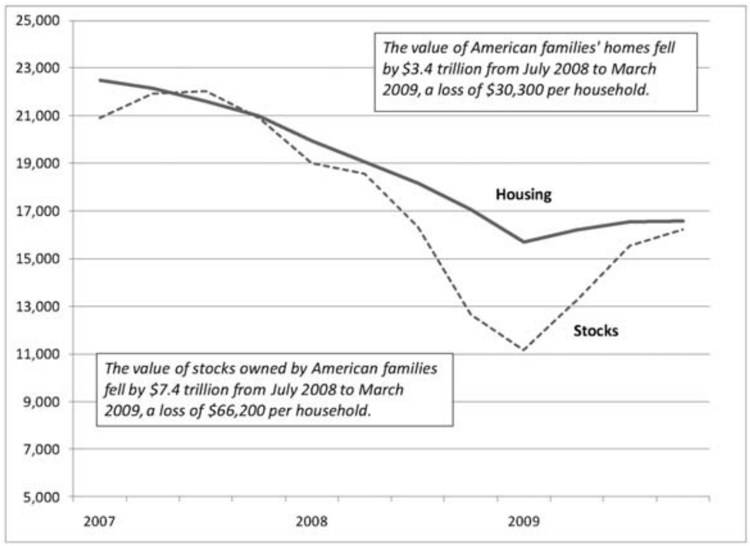


Note: Wages in billions of 2009 dollars.

The value of families' real estate holdings declined sharply over the crisis as well, with a loss of $5.9 trillion from mid-2007 to March 2009, or a loss of $3.4 trillion from mid-2008 to March 2009. These correspond to wealth losses of more than $52,900 per household in the longer period, or $30,300 per household for the shorter one. The modest rebound in the housing market in the latter part of 2009 has meant that the wealth loss from mid-2008 through the end of 2009 is $1.6 trillion, or $14,200 per household. Unlike the economic variables of output, employment, and wages, the wealth measures are not adjusted for the unexpected impact of the events of September 2008. This is because market-based measures of asset values in principle should already reflect the expectation of slower growth from the perspective of mid-2008. The unexpected plunge in the economy in late 2008 and into 2009 would not be reflected in asset values, however, making these valid measures of the impact of the acute stage of the crisis on household wealth.

Figure 4 shows that the financial crisis exacted an immense toll on household wealth. The value of families' equity holdings fell by $10.9 trillion from the middle of 2007 to the end of March 2009—the longest period of decline in the value of stock holdings. This equals a loss of $97,000 per household. Looking at the decline in the value of stock holdings only from the middle of 2008 to the end of March 2009 gives a loss of $7.4 trillion, or about $66,200 per household. The measure of stock market wealth includes both stocks owned directly by families and indirectly through ownership of shares of mutual funds. Data on wealth holdings are from the Federal Reserve's Flow of Funds database and are available quarterly. The wealth declines are thus measured starting from the end of June 2008 since the next quarterly value is for the end of September of that year and thus after the acute stage of the crisis had already begun. Stocks have rebounded over 2009, with the value of household equity holdings at the end of the year back to the same level as at the end of June 2008.

FIGURE 4: IMPACT OF THE CRISIS ON HOUSEHOLD WEALTH



Note: in billions of dollars.

Table 3 summarizes the economic impacts of the acute stage of the crisis that began in September 2008. By all measures, the acute phase of the financial crisis had a severe impact on the U.S. economy, with massive losses of incomes, jobs, wages, and wealth.

TABLE 3: ECONOMIC AND FISCAL IMPACTS OF THE CRISIS

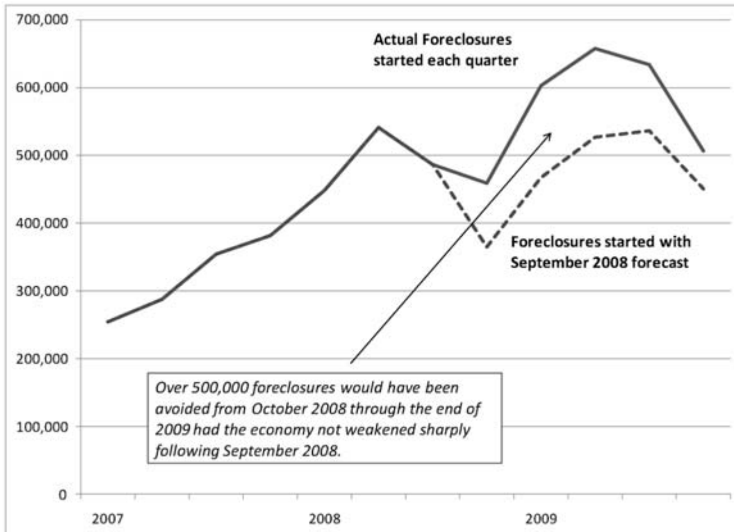
	Total impact of the crisis	Per Household Loss
GDP (total lost income)	$650 billion	$5,800
Employment (lost jobs)	5.5 million jobs	
Wages (total lost wages)	$360 billion	$3,250
Real estate wealth (July 08-March 09)	$3.4 trillion	$30,300
Stock wealth (July 08-March 09)	$7.4 trillion	$66,200
Fiscal cost (losses on TARP + GSEs)	$230 billion	$2,050

THE HUMAN DIMENSION OF THE CRISIS

Beyond dollars and cents, the financial crisis had substantial negative impacts on American families both at present and, likely, for decades to come as the hardships faced by children translate into changed lives into the future. The poverty rate, for example, increased from 9.8 percent in 2007 to 10.3 percent in 2008, meaning that an additional 395,000 families fell into poverty. There is not a simple relationship between economic growth and poverty, and poverty data are not yet available for 2009, but the weaker growth that resulted following the events of September 2008 surely sent thousands of additional families into poverty. And the crisis will have attendant consequences for other economic outcomes including the future prospects for employment and wage growth of those facing long spells of unemployment.

While it is not possible to count all of the ways in which the crisis affects the United States, a glimpse of the human cost of the crisis can be seen in the number of additional foreclosures started as a result of the severe economic downturn that began in September 2008. Millions of foreclosures were already likely even before the acute part of the crisis—the legacy of the housing bubble of these years was that too many American families got into homes that they did not have the financial wherewithal to afford. For other families, however, a lost job as a result of the severe recession translated into a foreclosure, and this can be estimated using a similar methodology as for the economic variables above.

FIGURE 5: IMPACT OF THE CRISIS ON FORECLOSURE STARTS



With the economy projected to remain weak in the second half of 2008 and into early 2009, and with many people deeply underwater with mortgages far greater than the value of their homes, there would still have been millions of foreclosure proceedings started. But the weaker economy following the acute phase of the crisis worsened the problem, layering the impact of an even weaker economy on top of the already difficult situations faced by many American families on the downside of the housing bubble.

CONCLUSION

The financial crisis of 2007 to 2010 has had a massive impact on the United States. Millions of American families suffered losses of jobs, incomes, and homes—and the effects of these losses will play out on society for generations to come. This paper quantifies some of these impacts, focusing on the aftermath of September 2008 and attempting to isolate the effects of the crisis from other developments. The result was hundreds of billions of dollars of lost output and lower wages, millions of lost jobs, trillions of dollars of lost wealth, and hundreds of thousands of additional foreclosures.

An alternative perspective would be to look at the overall impacts of the crisis from start to finish. This would be a broad view but a less well defined calculation: one could calculate economic impacts, for example, from the start of the housing bubble or from its peak. Or one could seek to exclude the offsetting impact of monetary and fiscal policy measures taken in response to the crisis and attempt to isolate the impact of the crisis alone.

These are different (and difficult) calculations to make, but some evidence can be garnered on the broader impacts of the crisis from start to finish. The International Monetary Fund, for example, estimates that U.S. banks will take total writedowns of just over $1 trillion on loans and asset losses from 2007 to 2010, including $654 billion of losses on loans and $371 billion of losses on securitized assets such as mortgage-backed securities.

The policy response to the crisis has involved massive fiscal costs, with U.S. public debt up substantially due to lower revenues and higher spending in response to the crisis, and this increase is forecast to continue under current law over the years to come. The declines in output and asset values and increases in U.S. public debt mirror the experience of other countries. As discussed by Reinhart and Rogoff (2009), banking crises across countries lead to an average decline in output of 9 percent, a 7 percentage point increase in the unemployment rate, 50 percent decline in equity prices, 35 percent drop in real home prices, and an average 86 percent increase in public debt.

Figure 1 of this analysis provides evidence connecting the results of this paper to this broader literature. One measure of the overall economic impact of the crisis is the output gap between actual and potential GDP. In 2008 and 2009 combined, this gap comes to $1.2 trillion, or $10,500 per household. This is a loss of nearly 5 percent of potential GDP in total over the two years—less than the 9 percent average loss across countries found by Reinhart and Rogoff, but the costs of the crisis calculated in this paper cover only part of the crisis and only through the end of 2009. As shown in Figure 1, GDP looks to remain below potential for years into the future, implying higher overall costs of the crisis.

The financial crisis of the past several years has had a massive economic cost for the United States—trillions of dollars of wealth and output foregone, millions of jobs lost, and many hundreds of thousands of families suffering hardship. These costs demonstrate the importance of taking steps to avoid future crises, and the value of reforms that help achieve this goal.

Mr. BERNANKE. So the cost of the policy response itself is pretty small, actually, because we are getting paid back the TARP money.

The cost of the recession and the financial crisis is very large. And I don't know, we can try to estimate that. But certainly it would have been much larger if we hadn't taken actions to prevent the collapse.

Ms. KAPTUR. Yes. But I think we need to get the bookends, how big this thing really is and also what is at risk into the future.

And that leads me to my second question in terms of the contracts that the Fed has signed with BlackRock. Could you provide for the record an update on the value of the contracts that the Fed has signed with them, the purpose of those contracts, and the results produced to date? That is just a request for information.

Mr. BERNANKE. Okay.

Ms. KAPTUR. Thank you.

Number three, how can you use your power—and this goes to the housing issue—how can you use your power as the Fed to get these megabanks and the servicers that they have hired to the table to do housing workouts to avoid the ghost towns and ghost neighborhoods that we are getting across this country? There is a real stop-up in the system, a real blockage. Even though, for example, home values have lost 30 percent of value, that isn't booked on the books of the banks. And you can't get a negotiation at the local level because there is nothing requiring the servicers to come to the stable. And there is a contractual relationship due to the subprime bonded nature of the instrument.

We need the Fed to take a look at this since you deal in the bond markets, and you deal with these companies anyway. We need to get people to the table. And with the number of underwater loans, this isn't going to get any better.

Across the country—I was talking to Dennis Cardoza yesterday, from California. He and I are in the same boat, and his boat is actually sinking faster than ours. And we really need somebody to hold these servicers accountable. Is there some way you can use your power to do that? That is question one.

And then, question two, since the crisis began, the megabanks actually have a larger share of assets in the market than they did at the beginning, and the big investment banks that are very important to the Fed and the way you operate particularly up there in New York. And they had about a third of the assets of the country prior to the crisis. They now have nearly two-thirds.

In the meanwhile, institutions in places like I represent are paying huge FDIC fees, up from maybe $20,000 5 years ago up to

$70,000 last year, this year $700,000. The reason that lending is constricted at the local level is because these large institutions are really holding so much of the power, and we don't have a really balanced financial system. So they are not making the small business loans. So my question is, what role can you play as the Fed in restoring prudent lending and broad competition across our financial system?

So question one relates to getting the servicers to the table, working with the megabanks. And number two, what can you do to help restore lending across this country through a competitive financial marketplace?

Mr. BERNANKE. Well, on the first, we have been working hard to support the Treasury's efforts to do HAMP renegotiations between borrowers and lenders. And we have made clear to the banks that they should participate and cooperate in those programs.

Ms. KAPTUR. With all due respect, Mr. Chairman, it is the servicers who aren't showing up, and it is a voluntary program. It is not working.

Mr. BERNANKE. Well, as supervisors, we can strongly encourage them to participate, but I think it is up to Congress to make it mandatory. We don't have the power to make it mandatory.

But certainly, we think it is good practice, it is good for the banks to get these things resolved. To have these loans in limbo is not good for the banks either. They need to get them resolved and stabilized as quickly as possible. So I think that there is a common interest here, and we are very interested in that point.

And the Cleveland Fed and other Feds also are very interested in neighborhood stabilization, which is a related issue. When you have a lot of foreclosures in a particular area, you have a breakdown in public order or in tax revenues and property values. So that is another issue where we have been very much involved.

But, again, I think the government's primary tool for this has been through the Treasury, and we have tried to support them both analytically and through our supervisory function.

On competition, actually, right now, I agree with you 100 percent that small banks are critical. We work with small banks all the time, and we were very concerned when the Senate was contemplating taking us out of the small bank supervision business because we find that those connections and that input we get from them and the interaction we have with them very, very important for our regulatory and monetary policies. So we are supporting them in every way we can.

I think, actually, what is happening now in many cases is that the large banks are pulling back because of, you know, a shortage of capital or because of conservatism, and it is the small community banks in many cases that are healthy, didn't have subprime mortgages and are coming forward and making the loans. So they are providing a very important service right now, and we certainly encourage that.

Ms. KAPTUR. Mr. Chairman, I know my time is up, but these fees on these smaller institutions are killing lending at the local level. Maybe you could take a look at that with Sheila Baird over at the FDIC.

Mr. MOORE. Thank you, Mr. Chairman.

Since this economic situation started back in 2008, we have seen in our country a significant rise in defaults on home mortgages. At the same time, the absence of the home buyers' tax credit will, I am afraid and I believe, lead to a decrease in demand. It would seem these happenings will cause housing prices to drop even more significantly in the future. What is the appropriate response of the Fed in such a scenario? What can the Fed do to address this situation, if anything?

Mr. BERNANKE. Well, the main thing we are doing, of course, is that we have purchased a large amount of mortgage-backed securities guaranteed by the government-sponsored enterprises. And right now, the 30-year mortgage rate is about 4.8 percent, so that is clearly going to make it accessible. Affordability right now in terms of house prices and interest rates is about the best it has been for a very long time.

You are right that the large amount of vacant and foreclosed properties is a major drag, particularly in some areas of the country. And I agree with Ms. Kaptur on this issue that we need to work with the Treasury and with the banks to do what we can to get these resolved as quickly as possible, whether it is through renegotiation of the mortgage, whether it is through a short sale or however it is done to get people situated and allow those houses to be turned over in the marketplace. So we are working to try to manage that situation. But that is clearly a big overhang for the housing market.

Mr. MOORE. That is my question. I appreciate your answer, Mr. Chairman. Thank you.

Chairman SPRATT. The chair now recognizes Mrs. Lummis. I beg your pardon for moving ahead of you. You have the floor for 5 minutes.

Mrs. LUMMIS. Thank you, Mr. Chairman.

Dr. Bernanke, I want to explore our entitlement programs with you for a little bit. We know, from visiting with Treasury Secretary Geithner, that Medicare is essentially bankrupt. We know that Social Security, when we get to the 2030s, will be taking in enough money only to pay out three-fourths of the benefits it pays out now if we do nothing.

So to help this committee dispel the persistent and dangerous myth that our entitlement programs are sustainable as currently structured, can you describe the fiscal and economic consequences of doing nothing on entitlements and simply allowing Social Security and Medicare to run their course?

And could you please put figure one back up? That was the one on the Tidal Wave of Debt. Because I am concerned about the effect of doing nothing with our entitlement programs on this very tidal wave.

Mr. BERNANKE. Well, you are correct that the entitlement programs are not self-funded. They are unfunded liabilities to a significant extent at this point. They are the biggest single component of spending going forward.

Now there are various ways to address this. You can restructure entitlement programs. You can cut other things. But at some point, you need to address the overall budgetary situation.

If you don't, you will get a picture like this one where interest rates are rising, interest payments are rising because the debt outstanding is growing exponentially. And at that point, things will come apart.

A famous economist once said, anything that can't go on forever will eventually stop. And this will stop, but it might stop in a very unpleasant way in terms of sharp cuts, a financial crisis, high interest rates that stop growth, continued borrowing from abroad.

So, clearly, we need to get control of this over the medium term, and we certainly are going to have to look at entitlements because that is a very big part of the obligations of the Federal Government going forward.

Mrs. LUMMIS. The only plan that I have seen that addresses entitlements and spending comprehensively is Ranking Member Ryan's plan that can be read on americanroadmap.org. Are you aware of any other plan to comprehensively address both entitlements and nonentitlement spending?

Mr. BERNANKE. I think Brookings and a few others have provided programs, but they are pretty rare. I agree with that.

Mrs. LUMMIS. You mentioned that we need to be careful in the short term about upsetting the apple cart. But we need to address these in the medium and long term. What to you is a good definition of medium to long term?

Mr. BERNANKE. Well, it depends to some extent on the rate of recovery of the economy. The more quickly it recovers, the sooner the medium term will come, in some sense.

But right now, the various estimates of the CBO and the OMB under different scenarios show a structural deficit from say 2013 to 2020 of between 4 and 7 percent of GDP, which is not sustainable. So I would say medium term is 3 to 5 years out in the future, and of course, the situation gets much more difficult beyond, say, 2020 when the entitlement spending becomes even greater.

Mrs. LUMMIS. I am aware that Mr. Ryan's plan has been scored by CBO and that it does not actually balance the budget until the second half of this century. That is how gentle a landing it is. And that is based on our current economic situation. So it would balance the budget earlier if there were a more robust economic recovery.

Does that number scare you as being too abrupt an effort to recover our economy and balance the budget?

Mr. BERNANKE. I am not familiar with the exact trajectory there, but I think we need to show that, within a few years, we are going to go clearly to a path where the debt-to-GDP ratio remains more or less stable. In other words, that line in that picture is flat or going down rather than rising, and as long as that can be persuasively shown to the public and to the markets, I think that would be a very important step.

Mr. RYAN. Would the gentlelady yield for just a brief moment?

Mrs. LUMMIS. Yes.

Mr. RYAN. Are you guys saying this is all about trajectory and confidence that this trajectory will be put in place?

Mr. BERNANKE. That is what I am saying.

Mr. RYAN. That is what we are trying to achieve.

Mr. BERNANKE. Yes.

Mrs. LUMMIS. Thank you, Mr. Chairman. Thank you, Mr. Bernanke.

Chairman SPRATT. Mr. Langevin.

Mr. LANGEVIN. Thank you, Mr. Chairman. Chairman Bernanke, thank you for being here today and the hard work you are doing. When you testified in front of this committee a year ago almost to the day, the economy was still in decline, gross domestic product decreased by over 6 percent and we were shedding about 500,000 jobs a month. I know we have talked about this again here this morning several times. Today our economy is growing at an estimated rate of about 3 percent, adding almost 300,000 jobs in April. That is a significant turnaround. However, in places like my home State in Rhode Island, which continues to have one of the highest unemployment rates in the country—a 12.5 percent rate right now—finding jobs really continues to be a top concern for me, for my constituents. And the other issue is the Federal deficit. I know these have been constant themes here this morning. So my question is that to both on small business job creation—and I do want to adjust the deficit. Small businesses are a key economic driver, particularly in Rhode Island, which we have about 97 or 98 percent of our businesses in Rhode Island are small businesses. Can you give us again an update on the current state of lending to small businesses? In particular, can you also give us an updated status report on the term asset backed lending facility, or TALF, as it relates to small business lending? And in your estimation, do small businesses now have access to the credit that they need to begin expanding and adding jobs? And in really going forward, what do you believe the most effective ways the Federal Government can spur small business growth and speed job creation? How do we really jump-start job creation in small businesses, which is the backbone of our economy, particularly in Rhode Island?

The other thing I would like you to get to—as I mentioned before, the deficit and our mounting Federal debt is another large concern for all of us, especially given the recent volatility in the European markets. Do you believe that our economy is stable enough to enact immediate deficit reduction measures? If not, what are the risks of a double-dip recession? And then finally, what are the most effective ways to enact appropriate deficit reduction so that we don't put our economic recovery at risk?

Mr. BERNANKE. So the credit situation for small businesses remains very tough, very tight. I think there are some indications of modest improvement. For example, our survey of loan officers suggests that they are no longer tightening the terms on which they offer loans to small businesses. And the rate at which small loans is declining is at least leveling off to some extent. So things are getting a little better. Another indicator is that—part of the reason it is getting a little better is maybe that right now businesses are not coming to the banks in many cases for loans because they don't have the demand for their product. If you ask small businesses in the surveys, most of them point to a lack of demand as the most important problem and then credit is down the list somewhere. And I think our concern is that as the economy grows and these businesses want to grow, that they will run into constraints.

So to answer your question, I think although there seems to be some signs of improvement—and I heard some of this last week in Michigan when I was talking to suppliers to the auto industry—some signs of improvement, it is still obviously very tight for small business. Our TALF program, I think, was very helpful in getting the securitization market for small business loans going again. That program is now over because we are trying to exit from those extraordinary measures. But the secondary market has seemed to have revived. In addition, the Treasury is purchasing SBA loans. But SBA is only one particular—is only one part of the source of credit for small business and that is why, as I have emphasized today, the Fed has been working very aggressively with banks to make sure that small businesses that are creditworthy are not turned away. I am sure we are not successful in all cases, but we understand the importance of this to recovery in this economy.

On the deficits, again as I said to Mr. Ryan, I think it is really a question of trajectory. A very sharp consolidation of fiscal policy this year would not be a good idea I think, given the fragility of the recovery at this point, but maintaining a strong recovery and keeping interest rates low would be assisted by a commitment by Congress to bring the deficit to a sustainable level and the debt to a relatively flat level to GDP over the medium term.

Chairman SPRATT. Ms. DeLauro.

Ms. DELAURO. Thank you very much, Mr. Chairman. Dr. Bernanke, welcome. Thank you.

As expressed here and in other forums, the concern about the adverse effect of a growing deficit and debt in the coming years and its long-term effect on our economy, I worry that there is a great deal of confusion about what the concerns imply about policy choices now and over the next few years. For instance, the concerns about the economic deficits and debt led some House Members to demand that the fiscal relief for the States in the form of a temporary extension of the increase in the Federal matching rate for Medicaid be dropped from the jobs bill the House passed before the recent break. You commented in your testimony about the shortfall in State budgets. Additional layoffs—and you mentioned something a little earlier on this—additional layoffs, and there appear to be substantial layoffs coming, particularly in education and that will follow with health care workers, probably with police and fire. And States are required to balance these budgets. What that means in terms of those layoffs if we do not extend additional FMAP funding for States, will that be a drag on the economy and slow recovery? I know you shy away from, as you should, talking about specific programs, but we are at an economic crisis at the moment here. We have to connect dots between Federal Government and State government with what is happening. What is your sense of this policy with regard to assistance with States at this juncture? At this juncture, not forever. At this juncture.

Mr. BERNANKE. Well, I am going to disappoint you to some extent because again I don't want to tell Congress which specific programs to undertake.

Ms. DELAURO. I understand.

Mr. BERNANKE. But to the extent that you decide to undertake short-term spending programs, whether it is to help the unemployed or to provide training or to help State and local governments or to provide infrastructure, those are the kinds of choices that you are looking at. To the extent you do that, it will be more effective and safer to do that on a twin-track basis where on the other track you are also thinking about the longer term. That is my message.

Ms. DELAURO. I understand that. The environment here today, which is one of concern, that we do not seem to be looking at—and this leads me to a following question, Dr. Orszag said in the paper the other day that there was no tradeoff between deficit reduction and job creation. Given what you have said, I am assuming that you have the same view on that, we are dealing with a 2-track program here. But Congress is becoming increasingly concerned that there is a tradeoff and that policies such as extending the unemployment benefits, doing something about an FMAP program are increasingly—we are not moving in that direction. That the only track is deficit reduction. So that my point to you is do you agree that there is no tradeoff, that both are the right goal? Do you think we can create jobs and show that in the long term we are serious about deficit reduction?

Mr. BERNANKE. Yes, but you have do both. That is my point.

Ms. DELAURO. Right. But we are in an environment in this institution, Dr. Bernanke, that says that it is one track, it is deficit reduction, it is not job creation or the measures one needs to deal with short-term economic recovery. I don't know if you are fearful—and I would ask you the question—that the current climate in the Congress, in both the House and the Senate, is the one track. And my question to you is, is that the appropriate direction to take? What kind of repercussions would result with that effort and saying to the States or saying to this effort on job creation, we can't do that now? What does that do overall to the recovery?

Mr. BERNANKE. I think that in the short term fiscal policy needs to take into account the fact that the recovery is still pretty fragile and may need some more assistance. Now, the risk there is if you do only that short-term type of activity, it may cause markets to worry that you are not serious and interest rates could go up and you would have that problem. I think we are in full agreement here.

Ms. DELAURO. We are in full agreement. What I am making the point is that we are in a climate, in an environment in the Congress that is one track. And my view—and I will just express my view—is that is not where the future economic recovery lies. I sense in your view it is the same and that we are on the same track. Deficit reduction clearly is something that we have to focus on. Thank you.

Chairman SPRATT. Ms. DeLauro, take yes for an answer and let us move on to the next question. Mr. Connolly. And this will be the last series of questions.

Mr. CONNOLLY. Thank you, Mr. Chairman. Dr. Bernanke, welcome. And I am sorry I am the last questioner. The stimulus that was passed by this Congress last year, was it necessary and did it work?

Mr. BERNANKE. I think it was helpful. I think it did create some jobs, it did create some growth. Whether it could have been done better, I don't know. But it was helpful. It did create some jobs. But again it has added—and again I am fine with the fact that it added to the deficit, but we need to take into account that long-term implication as we view fiscal policy going forward.

Mr. CONNOLLY. Let us go back to when we passed the stimulus. Was it useful or necessary to the economic recovery or could we have just gotten by without it?

Mr. BERNANKE. Sir, I don't want to buy into the entire package and all the aspects of it, the composition, the size, all of those things. But I do believe the fiscal policy was useful, it did help the economy recover and it helped create jobs.

Mr. CONNOLLY. Useful. Was stimulus necessary or not a little over a year ago? You will be one of the few economists I know of who thinks otherwise if the answer isn't yes.

Mr. BERNANKE. Again, I don't know what would have happened in the absence. I think it did add to jobs. It did help growth. And clearly we needed that help because the economy was in a very weak condition a year ago.

Mr. CONNOLLY. Thank you. You mentioned the deficit commission, Dr. Bernanke. I have heard members of this committee on the other side of the aisle say that they are all for addressing the deficits so long as it never involves any new revenue sources.

Can we, in fact, change the trajectory we are on in terms of deficit growth if we only address the spending side and don't address the revenue side?

Mr. BERNANKE. I think I would urge everybody to approach this with an open mind and be willing to look at all alternatives. Now, in the end, people have their own views and their own decisions to make. But I would think that we don't want to be carving off all possibilities before we get to——

Mr. CONNOLLY. I guess I am asking you a different question. I agree with you that everyone should keep an open mind. But I am telling you they don't have an open mind. They have publicly expressed that they do not favor—they are all for deficit reduction, as long as anything having to do with revenue is off the table.

Can we get to serious deficit reduction, change that trajectory you talked about, if we eliminate half of the legacy programs?

Mr. BERNANKE. Well, theoretically you could if you cut enough, but it would be very difficult to do that.

Mr. CONNOLLY. Is there enough spending to be cut?

Mr. BERNANKE. Of course.

Mr. CONNOLLY. National defense, homeland security?

Mr. BERNANKE. That is your judgment, that is the Congress' judgment. That is not my judgment.

Mr. CONNOLLY. It must be nice to be an economist. Your predecessor opined after the inauguration of President Bush that he did not think that the proposed tax cuts at that time would necessarily have a deleterious effect on the situation of the deficit and that it could have a stimulative effect on the economy. Was he right or wrong in that opinion, retrospectively?

Mr. BERNANKE. I think it probably did strengthen the economy but it probably also raised the deficit.

Mr. CONNOLLY. You think it strengthened the economy.

Mr. BERNANKE. In the sense—remember we were in 2001, we were in a recession and it was supportive of the recovery, I believe. However, it did add to the deficit.

Mr. CONNOLLY. But it didn't seem to have a sustained and positive impact on the economy if you look at what happened in 2007, 6 short years later, did it?

Mr. BERNANKE. That is certainly true. But the financial crisis, I think, was a somewhat separate set of factors that hit the economy.

Mr. CONNOLLY. You are referring to the economic decline after 9/11 in 2001?

Mr. BERNANKE. There was a recession that began before—it came after the drop in the tech bubble, the dot-com bubble. March 2001, the recession began.

Mr. CONNOLLY. My final question, because my time is up and so is yours. Taxes. There was a study released a few weeks ago that showed that the cumulative aggregate tax burden, State, local and Federal, on the average household in America is now at its lowest point since 1950 when Harry Truman was in the White House. Is that your understanding as well?

Mr. BERNANKE. That may be true, but I think it is at least in part due to the fact that we are in a deep recession. So people's incomes are down and so the amount of taxes they pay are less than usual. I am not sure that is true about each individual tax in terms of rates and so on.

Mr. CONNOLLY. Were taxes cut as part of the stimulus bill last year?

Mr. BERNANKE. Yes.

Mr. CONNOLLY. Thank you. I yield back, Mr. Chairman. Thank you, Dr. Bernanke.

Chairman Spratt. The gentleman yields back. Mr. Chairman, thank you very, very much for finding the time to testify and for your full and forthright answers.

Those members who did not have an opportunity to submit questions may submit questions for the record if there is no objection. There is none. So ordered.

Thank you once again for coming. We very much appreciate your testimony and your service to our country.

[Questions submitted and their responses follow:]

QUESTIONS SUBMITTED FOR THE RECORD TO CHAIRMAN BERNANKE

Congressman Aderholt

1. On April 1, the Federal Reserve began requiring escrow accounts to be established for first-lien higher-priced mortgage loans. Many community banks protested this requirement since they do not have the resources to create these escrow accounts. Since the rule went into effect, many community banks, including one in my district, have stopped offering these mortgages. Is the Federal Reserve reviewing this policy and how it affects community banks? Do you foresee the Federal Reserve exempting community banks from this regulation in the near future?

2. I hear stories from community bankers in my district about overzealous regulators going so far as to demand changes on individual $8,000 car loans. Do you believe that some of this over regulation could hinder our economic recovery more than help it? Will increased regulations in the financial reform legislation in Congress decrease the availability of credit to consumers, especially from small banks?

3. During the hearing, you stated that some banks are taking second looks at loan applications to ensure consumers get the credit they deserve. In discussion with small bankers in my district, I have learned that many community banks are taking second, third and fourth looks. While it is good that they are reviewing these applications, it is slowing down access to credit. The fact is that many of these banks

are afraid to lend money. What is the Federal Reserve doing to give community banks more confidence in lending and free up credit for consumers?

Congresswoman Kaptur

1. Mr. Chairman, what role, if any, should the Federal Reserve System play in working to solve the housing crisis continues to ravage our nation's communities?

2. Mr. Chairman, the Treasury is pouring money into Fannie and Freddie, keeping it afloat to support the current structure of housing finance. What should be done to stop us from dumping money into Fannie and Freddie to cover the losses of bad paper dumped into both institutions by big banks at profits and to return our housing finance system to a prudent lending, sound system that supports homeownership and affordable housing?

3. Mr. Chairman, in the House bill on financial regulatory reform, we created the Consumer Financial Protection Agency. In the Senate bill, a bureau was created within the Federal Reserve System, underneath the Board of Governors. The conference is using the Senate bill as the base bill for discussion. Therefore, Mr. Chairman, do you feel that the Federal Reserve should have any responsibility for consumer protection? Do you feel that this fits in with the roles of the Federal Reserve System, which is to formulate the nation's monetary policy, supervise and regulate banks, and provide a variety of financial services to depository financial institutions and the federal government? Please including any related information to support your responses.

RESPONSES TO MR. ADERHOLT'S QUESTIONS FROM CHAIRMAN BERNANKE

1. On April 1, the Federal Reserve began requiring escrow accounts to be established for first-lien higher-priced mortgage loans. Many community banks protested this requirement since they do not have the resources to create these escrow accounts. Since the rule went into effect, many community banks, including one in my district, have stopped offering these mortgages. Is the Federal Reserve reviewing this policy and how it affects community banks? Do you foresee the Federal Reserve exempting community banks from this regulation in the near future?

As you note, the Board's rules for higher-priced mortgage loans require that creditors establish escrow accounts for taxes and insurance. The Board issued these rules in July 2008 using its authority under the Home Ownership and Equity Protection Act to prohibit unfair practices in connection with mortgage loans. Compliance with the rule did not become mandatory until this year because the Board recognized that some lenders would need time to develop the capacity to escrow.

As background, the Board adopted the escrow requirement to address specific concerns. The Board found that lenders generally did not establish escrow accounts for consumers with higher-priced loans. The Board was concerned that when there is no escrow account, lenders might disclose a monthly payment that includes only principal and interest. As a result, consumers might mistakenly base their borrowing decision on an unrealistically low assessment of their total mortgage-related obligations. The Board was also concerned that consumers not experienced at handling taxes and insurance on their own might fail to pay those items on a timely basis.

Nonetheless, we do appreciate the concerns you have raised about the cost of establishing escrow accounts, and whether the cost may be prohibitive for lenders that make a small number of loans and hold them in portfolio. In fact, community banks also have raised these concerns with the Board directly during the past several months. As a result, we have been discussing with their representatives the potential impact of the escrow rule. Please be assured that the Board is monitoring implementation of the new escrow rule by small lending institutions and the availability of credit in the communities they serve. If it is determined that the costs of the rule outweigh the benefits, we will explore alternatives that do not adversely affect consumer protection.

2. I hear stories from community bankers in my district about overzealous regulators going so far as to demand changes on individual $8,000 car loans. Do you believe that some of this over regulation could hinder our economic recovery more than help it? Will increased regulations in the financial reform legislation in Congress decrease the availability of credit to consumers, especially from small banks?

In retrospect, loan underwriting standards became too loose during the run up to the recent financial crisis. Accordingly, some tightening of underwriting standards from the practices that prevailed just a few years ago was needed. However, as your question suggests, there is a risk that over-correction by banks and supervisors could unnecessarily constrain credit. To address this risk, the Federal Reserve and the other banking agencies have repeatedly instructed their examiners to take a measured and balanced approach to reviews of banking organizations and to encourage efforts by these institutions to work constructively with existing borrowers that are experiencing financial difficulties. Examples of such guidance include the November 12, 2008 Interagency Statement on Meeting the Needs of Creditworthy Borrowers and an October 30, 2009 interagency statement designed to encourage prudent workouts of commercial real estate loans and facilitate a balanced approach by field staff to evaluating commercial real estate credits (SR 09-7). More recently, on February 5, the Federal Reserve and other regulatory agencies issued a joint statement on lending to creditworthy small businesses. This statement is intended to help to ensure that supervisory policies and actions are not inadvertently limiting access to credit. If bankers in your district believe that Federal Reserve examiners have taken an inappropriately strict approach on a supervisory matter, they should discuss their views with bank supervision management at their local Reserve Bank or raise their specific concerns with the Federal Reserve's ombudsman (see details on the Board's website at *http://www.federalreserve.gov/aboutthefed/ombudsman.htm*).

Regulation imposes costs on small banks and can affect their capacity and willingness to lend. However, on balance, it is likely that the benefits of implementing reforms to prevent a future financial crisis outweigh the costs of these changes. Indeed, a repeat of the recent crisis in all likelihood would be far more costly to community banks and consumers seeking credit than the costs of the proposed financial reform package.

3. During the hearing, you stated that some banks are taking second looks at loan applications to ensure consumers get the credit they deserve. In discussion with small bankers in my district, I have learned that many community banks are taking second, third and fourth looks. While it is good that they are reviewing these applications, it is slowing down access to credit. The fact is that many of these banks are afraid to lend money. What is the Federal Reserve doing to give community banks more confidence in lending and free up credit for consumers?

As discussed above, the Federal Reserve has developed guidance for its examiners to ensure that they are taking a measured approach to evaluating lending activities at small banks. In addition, the Federal Reserve has supplemented these issuances with training programs for examiners and outreach to the banking industry to underscore the importance of the guidance and ensure its full implementation. Also, in an effort to better understand small business lending trends, the Federal Reserve System this month is completing a series of more than 40 meetings across the country to gather information that will help the Federal Reserve and others better respond to the credit needs of small businesses. As part of this series, the Federal Reserve Bank of Atlanta hosted five small business roundtable discussions at locations across its district during the spring and summer. Emerging themes, best practices, and common challenges identified by the meeting series were discussed and shared at a conference held at the Federal Reserve Board in Washington in early July.

RESPONSES TO MS. KAPTUR'S QUESTIONS FROM CHAIRMAN BERNANKE

1. Mr. Chairman, what role, if any, should the Federal Reserve System play in working to solve the housing crisis continues to ravage our nation's communities?

The Federal Reserve has addressed the housing market crisis with a variety of policy actions. First, the Federal Reserve has used conventional and less conventional monetary policy tools, maintaining the federal funds rate near zero and purchasing $1.7 trillion of securities, including more than $1.25 trillion in mortgage-backed securities guaranteed by the housing-related government-sponsored enterprises. Mortgage interest rates are now, in part because of these efforts, at historically low levels.

Second, the Federal Reserve has taken a number of regulatory actions designed to protect consumers and restore confidence in the housing market. Specifically, the Federal Reserve finalized revisions to Regulation Z in 2008, which provide a layer of protections and restrictions on higher-priced mortgage loans. Currently, the Board is engaged in a comprehensive review of the mortgage disclosures required under the Truth in Lending Act, to improve their utility and effectiveness. The Board has also joined fellow banking regulators in proposing rules under the S.A.F.E. Act.

Third, we have worked with market participants and other governmental agencies to encourage sustainable loan modifications and other activity to prevent avoidable foreclosures whenever possible. We have developed a number of consumer education materials, such as a series of advertisements in targeted movie theatres warning consumers about "foreclosure rescue" scams. For struggling communities, we have supported stabilization efforts, including a Federal Reserve system-wide research initiative to benefit communities engaged in HUD's Neighborhood Stabilization Program (NSP). We are also in the midst of several efforts (joint with other regulators) to alter the Community Reinvestment Act in part to encourage bank participation in hard-hit communities.

2. Mr. Chairman, the Treasury is pouring money into Fannie and Freddie, keeping it afloat to support the current structure of housing finance. What should be done to stop us from dumping money into Fannie and Freddie to cover the losses of bad paper dumped into both institutions by big banks at profits and to return our housing finance system to a prudent lending, sound system that supports homeownership and affordable housing?

There are a variety of organizational forms that might replace Fannie Mae and Freddie Mac that could likely provide mortgage credit without the systemic risks associated with these institutions in the past. I have spoken on this topic at length, arguing that we must strive to design a housing financing system that ensures the successful funding and securitization of mortgages during times of financial stress, but that does not create institutions that pose systemic risks to our financial market and the economy.[1] The Secretary of Treasury has also testified at length on this issue and the Administration is currently soliciting the public's views about how best to reform

[1] See Ben Bernanke "The Future of Mortgage Finance in the United States," at the UC Berkeley/UCLA Symposium on "The Mortgage Meltdown, the Economy, and Public Policy," October 31, 2008.

the housing finance system.[2] Among the objectives of reform he described was the need for accurate, transparent and risk-based pricing of government guarantees. I agree with the Secretary that any reform proposal should encourage this type of pricing for government guarantees. Such explicit pricing is a key step toward stopping any transference of bad assets by the private sector to government agencies or enterprises, and for encouraging prudent lending and a sound mortgage finance system that supports homeownership and affordable housing.

3. Mr. Chairman, in the House bill on financial regulatory reform, we created the Consumer Financial Protection Agency. In the Senate bill, a bureau was created within the Federal Reserve System, underneath the Board of Governors. The conference is using the Senate bill as the base bill for discussion. Therefore, Mr. Chairman, do you feel that the Federal Reserve should have any responsibility for consumer protection? Do you feel that this fits in with the roles of the Federal Reserve System, which is to formulate the nation's monetary policy, supervise and regulate banks, and provide a variety of financial services to depository financial institutions and the federal government? Please include any related information to support your responses.

The Federal Reserve Board believes that consumer protection is vitally important to the strength of the economy and to maintaining financial stability. Strong consumer protection helps preserve households' savings, promotes confidence in financial institutions and markets, and adds materially to the strength of the financial system. We have seen in this crisis that flawed or inappropriate financial instruments can lead to bad results for families and for the stability of the financial sector. It is essential that consumers be protected from unfair and deceptive practices in their financial dealings. The Federal Reserve System will support the new Consumer Financial Protection Bureau and will work to efficiently and effectively carry out the will of Congress regarding responsibility for consumer protection.

[2] See written testimony to the House Committee on Financial Services by Treasury Secretary Geithner March 23, 2010.

[Whereupon, at 12:20 p.m., the committee was adjourned.]

○